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THE EAST ASIAN DILEMMA:  
RESTRUCTURING OUT OR GROWING OUT?

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YUNG CHUL PARK



INTERNATIONAL ECONOMICS SECTION

DEPARTMENT OF ECONOMICS  
PRINCETON UNIVERSITY  
PRINCETON, NEW JERSEY

## ESSAYS IN INTERNATIONAL ECONOMICS

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## CONTENTS

1	INTRODUCTION	1
2	PROGRESS AND PROSPECTS OF THE FINANCIAL AND CORPORATE RESTRUCTURING IN EAST ASIA	2
	Indonesia	7
	Korea	11
	Malaysia	15
	Thailand	19
3	THE FORCES DRIVING THE EAST ASIAN RECOVERY	22
	Financial and Corporate Restructuring and Recovery	22
	Engines of Recovery	26
4	STRUCTURAL REFORM: AN ASSESSMENT	32
	Dismantling the East Asian Model	32
	Institutional Weaknesses	35
5	A BLURRED ROAD MAP FOR THE IMF PROGRAMS	36
	Setting Operational Reform Targets	37
	Conflicts between Reform Objectives	38
	The Fallacy of Banking Reform before Corporate Restructuring	40
6	AN AGENDA FOR SUSTAINING RECOVERY	43
	Setting Priorities	43
	Distortions and Inefficiency	45
7	GROWING OUT RATHER THAN RESTRUCTURING OUT	51
	The Limit of Restructuring Out	51
	Growing Out	56
8	MARKET-BASED OPERATIONAL RESTRUCTURING AND INSTITUTIONAL REFORMS	57
	Market-Based Restructuring	58
	Institutional Reforms: A New East Asian Paradigm	60
9	CONCLUDING REMARKS	63

APPENDIX A: POLICY RESPONSES TO FINANCIAL CRISIS IN INDONESIA, KOREA, MALAYSIA, AND THAILAND	66
APPENDIX B: FINANCIAL REPRESSION AND CRONY CAPITALISM	84
REFERENCES	92

## TABLES

1	Nonperforming Loans, Recapitalization Requirements, and the Costs of Restructuring, Mid-1999	4
2	Financial-Distress Resolutions and Bank-Recapitalization Strategies, 1997–1999	6
3	Macroeconomic and Policy Indicators, 1993–2000	24
4	Sovereign-Credit Ratings, 1997–2000	27
5	Quarterly Macroeconomic Indicators, 1997–2000	28
6	Measures of Corporate Profitability in East Asia, 1988–1996	48

## FIGURES

1	Quarterly GDP Growth Rates, 1997–2000	22
2	Incremental Capital-Output Ratios, 1991–1996	47





## THE EAST ASIAN DILEMMA: RESTRUCTURING OUT OR GROWING OUT?

### 1 Introduction

The financial crisis that spread from Thailand in June 1997 to Indonesia, Korea,<sup>1</sup> and Malaysia had devastating effects on the East Asian economy. It brought about a deep recession in the region, causing a sharp decline in living standards, a rise in unemployment, an industrial breakdown, and social dislocation. East Asia, which had once been proud of its status as an “economic miracle” was suddenly seen as a haven of reckless investors, opaque and insolvent financial institutions, highly leveraged corporations, corrupt governments, and crony capitalism.

Since early 1999, however, these four economies have managed impressive recoveries. All of them, except Indonesia, have recorded substantial growth, ranging from 4.2 percent in Thailand to over 10 percent in Korea. Even more encouraging is the expectation that the current recovery can be sustained, raising the hope that the region will grow out of the crisis sooner than expected.

Not everyone is sanguine about East Asia’s prospects for growth, however. Some argue that, although the recent recovery has brightened the region’s economic prospects, it has also encouraged a false sense of complacency that has increased resistance to reform from financial institutions, corporations, labor organizations, and, most of all, politicians.

Paul Krugman (1999) and many others warn that the structural vulnerabilities that brought the crisis countries to their knees are still present and that these countries’ prospects are not as promising as some claim. The International Monetary Fund (IMF) and the World Bank echo this concern and emphasize that only additional and more

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<sup>1</sup> Here and throughout, Korea refers to the Republic of Korea.

aggressive financial and corporate restructuring will provide the economic foundation necessary for both durable growth and a quicker recovery (Fisher, 1999; World Bank, 2000b, chap. 7).

The East Asian crisis countries have, therefore, reached a critical juncture. Unless they can develop a policy regime that allows them to pursue recovery and reform simultaneously, they must decide whether to intensify structural-reform efforts at the risk of interfering with the ongoing recovery or to give priority to the fragile recovery, even if doing so means derailing the reform process.

This essay analyzes the progress and prospects of structural reform in East Asia in order to identify the policy choices that will help the crisis countries accelerate their economic recovery without jeopardizing the reform process. Section 2 discusses the central features of the reform programs and analyzes their progress. Section 3 examines the forces driving the East Asian recovery. Section 4 assesses progress toward financial and corporate restructuring, and Section 5 reviews some of the weaknesses of the IMF programs. An agenda for sustaining the current recovery is proposed in Section 6. Proposals for a growing-out strategy are discussed in Section 7, and procedures for a market-based operational restructuring with institutional reform are reviewed in Section 8. Section 9 concludes the essay. Two appendices provide a historical table of events and an analysis of the primary causes of the region's crisis.

## **2 Progress and Prospects of the Financial and Corporate Restructuring in East Asia**

A central element of the IMF programs for Indonesia, Korea, and Thailand was an extensive array of structural reforms based on the liberal ideology of the "Washington Consensus."<sup>2</sup> These reforms ranged from the operational restructuring of insolvent financial institutions and firms to improving corporate governance, addressing labor-market rigidities, opening domestic markets, and introducing a free-floating exchange-rate system. They were intended to build a strong foundation for the recovery of sustainable growth by correcting what the IMF considered to be the structural weaknesses that contributed to the crisis. The strategy at the outset was to deal with the immediate

<sup>2</sup> Much of the statistical and factual information in this section is drawn from the World Bank (1999a, 2000a, 2000c).

crisis and to stop the bleeding,<sup>3</sup> as well as to restore confidence in the markets and attract capital inflows through a combination of institutional reforms and financial and corporate restructuring. Because the IMF determined that distortions and weaknesses in the financial sector were critical to the systems' failures, financial restructuring was considered to be a crucial element in minimizing the likelihood of another crisis (Lane et al., 1999).

Martin Feldstein (1998), Jeffrey Sachs (1998), and many other critics of the IMF programs, however, argue that what the crisis countries needed (except, perhaps, Indonesia) was coordinated action by exposed foreign financial institutions to restructure their short-term debt by lengthening debt maturity and providing additional credits to help meet interest obligations. Because the essential problem was one of liquidity exacerbated by financial panic and herding, these economies did not need reforms to restore their access to international capital markets.<sup>4</sup>

These critics' arguments are often summarily dismissed by IMF officials as reflecting ignorance of the real nature of the crisis, because the IMF believes the collapse was caused by an accumulation of structural weaknesses rather than by short-run macroeconomic imbalances. Attempting to ease the liquidity problem without structural reforms would thus be akin to treating symptoms without curing the disease. Furthermore, because there were complementarities among the respective reform measures, abandoning some of the reforms from the package, they argue, would have reduced the effectiveness of other reforms (Lane et al., 1999).

Over the past two years, the East Asian crisis countries have made great strides in resolving insolvent financial institutions and recapitalizing

<sup>3</sup> The short-run priorities were to stop bank runs, protect the payment system, and stem capital outflows.

<sup>4</sup> To be fair, it is difficult to determine empirically at this stage whether structural weaknesses made a crisis inevitable or whether foreign investors triggered the crisis when they abruptly altered their expectations about the future course of the crisis countries' development. Furman and Stiglitz (1998, pp. 58, 60) suggest that "there is little evidence that news about the degree of transparency or about fundamental variables that are related to the crises played an important role in the case of East Asia. . . . [and] there is little basis for claiming that corruption increased markedly in the run-up to the crisis." Stiglitz (1999, p. 4) also asserts that "in the aftermath of the crisis, the countries in East Asia were the victims of extensive criticism [for their structural problems]. . . . [T]his rhetoric gradually diminished, but may well have done its damage . . . in terms of the adverse views of the outside investment community." See also Radelet and Sachs (1998a, 1998b) and Chang and Velasco (1998).

weak but viable firms. Somewhat less significant is the considerable progress made in corporate-debt workouts and in operational restructuring. Their achievements are, indeed, impressive, but much remains to be done (Claessens, Djankov, and Klingebiel, 1999).

Most of the banks in the crisis countries remain undercapitalized and still hold sizable nonperforming loans (NPLs) on their balance sheets (Table 1). The application of stricter criteria for loan classification, or forward-looking criteria that include expected future earnings of borrowers at banks, is likely to require more provisioning and to reveal additional capital shortages in the near future. These shortages, together with the necessity of meeting an international capital-adequacy ratio (CAR), will require further bank recapitalizations. According to World Bank estimates, capital shortages as a percentage of total bank assets

TABLE 1  
NONPERFORMING LOANS, RECAPITALIZATION REQUIREMENTS, AND THE COSTS OF  
RESTRUCTURING, MID-1999  
(Percent)

	Indonesia	Korea	Malaysia	Thailand
NPLs (% of total bank loans)	60-75 <sup>a</sup>	8.5 <sup>b</sup>	22.0 <sup>c</sup>	46.5 <sup>d</sup>
Estimates at end-June 2000 <sup>e</sup>	(58.7)	(12.2)	(23.2)	(34.8)
Current capital (% of total bank assets)	-15.1	-1.0	1.8	-4.5
Capital shortfall (% of total bank assets) <sup>f</sup>	18.5	4.0	1.7	8.1
Gross cost (% of GDP)	45.0	15.0	12.0	32.0 <sup>g</sup>
Fiscal-recapitalization cost (% of GDP)	37.3	15.8	10.9	17.4
Expected additional fiscal cost (% of GDP)	12.7	10.7	5.5	15.4

SOURCES: Claessens, Djankov, and Klingebiel (1999); Lindgren et al. (1999); World Bank (2000b); and above.

<sup>a</sup> End-March, Radelet (1999).

<sup>b</sup> End-March, 1999.

<sup>c</sup> End-July, 1999.

<sup>d</sup> End-June, 1999.

<sup>e</sup> World Bank, (2000c).

<sup>f</sup> Assumes a 40 percent recovery rate on NPLs, a constant ratio of loans to deposits, and loan growth in line with GDP growth. The capital shortfall is applied to the entire banking system.

<sup>g</sup> As of November 1998, IMF (1998).

range from 1.7 percent in Malaysia to 18.5 percent in Indonesia. Despite progress in corporate restructuring, therefore, many firms, both small and large, are saddled with huge, unserviceable, debts and with unprofitable investments that will have to be written off (Claessens, Djankov, and Klingebiel, 1999).

Among the four crisis countries, only Korea and Malaysia have actively intervened to address the insolvency of financial institutions and overindebtedness of corporations. Partly as a result of this intervention, Korea has achieved a great deal more than the other three countries (although it still has a long way to go before completing the IMF reform program). Thailand, by contrast, has relied more on a market-based strategy, in which banks are allowed to raise equity capital over a long period through phased-in requirements for loan provisioning. Malaysia, which decided not to accept the IMF's rescue plan but to go its own way, has nevertheless taken many radical measures to deal with the crisis. Indonesia has only recently taken steps to deal with its banking problems and corporate distress, and it lags behind the other three countries (Table 2).

In all of these countries, four elements characterize the financial-sector reform. First, immediately after the crisis began, priority was placed on stabilizing the financial markets and on preventing bank runs and capital flight. In the absence of a deposit-insurance scheme, some of the crisis-country governments had therefore to guarantee deposits and other bank liabilities.

A second element involved liquidations, mergers, and government takeovers of failed banks and other insolvent institutions. This was followed by recapitalizing and rehabilitating weak but viable financial institutions through the infusion of public funds. Banks receiving public support were required to implement drastic changes in their management and operational structures. Malaysia, Korea, and, most recently, Indonesia established centralized and state-owned asset-management companies to dispose of NPLs. Thailand, by contrast, adopted a decentralized approach, in which each bank is encouraged to establish its own asset-management company, to which it can transfer assets at market value.

Third, banks were mandated to meet the international standards of capital adequacy, loan classification, provisioning, and accounting and disclosure requirements. Together with these changes, banks were asked to introduce new corporate governance and to develop a new operational framework for prudent risk management and sound lending practices.

TABLE 2  
FINANCIAL-DISTRESS RESOLUTIONS AND BANK-RECAPITALIZATION STRATEGIES, 1997–1999

	Indonesia	Korea	Malaysia	Thailand
Initial government liquidity support As percent of GDP	\$21.7 billion 17.6	\$23.3 billion 5	\$9.2 billion 13	\$24.1 billion 20
Financial-distress resolutions				
(1) Bank shutdowns	64 of 237	0	0	1 of 15
(2) Shutdowns of other financial institutions	Not applicable	More than 117	0	57 of 91
(3) Mergers of financial institutions	4 of 7 state banks to merge	11 of 26 banks absorbed by others	58 banks to be merged into 6 groups	3 banks and 12 finance companies
(4) Nationalizations	12	4	1 bank; 3 finance companies	4
Instrument used/assets received for bank resolution and recapitalization for (1), (2), and (3)	(1) bonds/equity (2) bonds/NPLs (3) debt-to-equity conversions/equity	(1) bonds or cash/equity or preferred shares (2) shares/NPLs	(1) bonds or cash/convertible preferred shares or subordinated debt (2) bonds/NPLs (3) bonds/subordinated debt	(1) debt-to-equity conversions/equity (2) bonds/equity (3) bonds/subordinated debt
Asset-management companies (AMCs)	Became fully operational in April 1998 within IBRA	KAMCO reconstituted as an AMC in late 1997	Danaharta established in mid-1998	FRA to auction off assets of closed financial companies
Amounts purchased by AMCs at end-April 1999 as percent of GDP	20	10	17 <sup>a</sup>	17.5 <sup>b</sup>

SOURCES: Claessens, Djankov, and Lang (1999); Lindgren et al. (1999).

<sup>a</sup> End-June 1999.

<sup>b</sup> Includes 4 percent purchased by national AMC, which was established to act as a bidder of last resort for assets of closed finance companies.

Fourth, in order to restructure overindebted and insolvent corporations, the East Asian crisis countries have, among other measures, eliminated tax and other regulatory obstacles to mergers, implemented debt-equity swaps and bankruptcy procedures, established out-of-court settlements for debt workouts (London Approach), enforced bankruptcy procedures, improved corporate governance, and broadened ownership.<sup>5</sup>

The following subsections briefly summarize recent developments in financial and corporate restructuring in the four crisis countries.

### *Indonesia*

At the end of October 1997, three months after accepting the first IMF rescue plan, there had been little improvement in the Indonesian economy. In fact, market confidence in the economy continued to weaken, and in January 1998, the Indonesian authorities, intent on stopping the bank runs, issued external guarantees to all creditors and depositors of locally incorporated banks and promised compensation to all small depositors at banks that had closed.

Since then, the Indonesian financial restructuring has focused on restoring market confidence, establishing an institutional framework for bank resolution and recapitalization, and strengthening a small group of healthy banks to stabilize the payment system and credit flows (World Bank, 2000a). In line with this strategy, two institutions were created for financial restructuring: the Indonesian Bank Restructuring Agency (IBRA), which was designed as an independent organization to restructure troubled banks and their assets, and the Asset Management Unit within IBRA, which was created to acquire NPLs from closed or merged banks. Indonesia's efforts also included a bank-recapitalization scheme in September 1998 and the closure of nonviable banks.

At the end of 1999, IBRA had assets worth Rp441 trillion (about US\$62 billion).<sup>6</sup> The agency, however, has done little since 1999 to resolve and recover these assets, although the legal, organizational, and regulatory framework for debt resolution has been in place. At the time of its creation, the IBRA was expected to be the key institution supporting Indonesia's restructuring efforts. From its inception, however,

<sup>5</sup> The London Approach refers to out-of-court settlements of unsustainable corporate debt. This approach, which was adopted by the Bank of England during the U.K. recession of the mid-1970s, urges both creditors and debtors to adhere to a set of principles such as continuing financial support to viable debtors and minimizing losses to creditors in out-of-court restructurings.

<sup>6</sup> Here and throughout, "billion" equals one thousand million.



it has suffered from a lack of transparency, from political interference, and from weak internal controls and governance. As a result, it has been unable to establish its credibility as an independent organization.

Only in the second half of 1999 did the Indonesian authorities take steps to assess the soundness of domestic private banks and to restore the health and profitability of the banking sector. As a result of this delay, most institutions still remain insolvent or undercapitalized, their lending severely curtailed. Some estimates maintain that NPLs account for as much as 60 to 75 percent of total loans outstanding (Table 1). At the end of 1999, the banking sector as a whole showed a negative net worth amounting to 15.1 percent of its total assets. The IMF estimates that the costs of bank restructuring will be about 45 percent of the gross domestic product, but many observers believe the final tally will be higher (Radelet, 1999).

At the end of July 1997, there were 160 private banks in Indonesia. According to the bank-recapitalization strategy announced in September 1998, all private banks were classified as A, B, or C, based on their CARS, and all Group C and nonviable Group B banks were to be closed.<sup>7</sup> Over the period of a year, sixty-eight banks were closed, thirteen were taken over by the state, and four of the seven state banks were merged to become a new bank, Bank Mandiri. The three remaining state banks are also scheduled for restructuring and it is expected that eight of the thirteen nationalized banks will be merged with Bank Danamon, which is owned by the IBRA. At the time of the recapitalization, although seventy-three private banks met the 4 percent CAR, these banks accounted for only 5 percent of total bank deposits.

As a result of the restructuring of the private banks, the state banking system now accounts for 75 percent of the total liabilities of the banking system and 90 percent of its negative net worth. Although the state banks are largely responsible for the losses of the banking system, the restructurings, mergers, and privatizations of these banks have only just begun in earnest and will be a significant challenge in the coming years.

As in the other crisis countries, the absence of an effective bank-supervision system in Indonesia was one of the leading causes of the banking-system collapse. Realizing this weakness, the Indonesian authorities have taken measures to improve prudential norms, bank supervision, and enforcement capabilities. The senior management at the central bank, however, which is in charge of the supervision, has

<sup>7</sup> Group A comprised banks with a CAR over 4 percent; group B included those with a CAR between 4 and -25 percent; group C included the banks remaining.

been reluctant to enforce existing prudential regulations and has not yet accorded a high priority to supervision. This reluctance, combined with a lack of trained staff, means that bank supervision remains very limited (World Bank, 1999a).

At present, the bank-recapitalization plan has been nearly completed. Although it has not yet succeeded in restoring soundness to the banking system, the Indonesian authorities are now turning to broadening and strengthening nonbank financial institutions and capital markets.

As for corporate restructuring, the Indonesian authorities have developed an elaborate policy and institutional framework that includes:

- The Jakarta Initiative Task Force (JITF) for voluntary corporate restructuring and out-of-court settlements for debt workouts (London Approach);
- The Indonesian Debt Restructuring Agency (INDRA) to act as an intermediary between debtors and creditors and to enable debtors and creditors to protect against exchange risk;
- A new bankruptcy law and commercial court.

Despite the existence of such a comprehensive framework and the fact that nearly half of all Indonesian corporations are insolvent and that difficulties in meeting debt obligations are widespread, little has been done about corporate restructuring in Indonesia. At the end of March 2000, 331 debtors were registered at the JITF, accounting for US\$23.4 billion in foreign debt (from a total of US\$70 billion) and Rp 14.6 trillion in domestic debt (from a total of Rp 215 trillion). Of these debtors, sixty-nine had standstill agreements. The JITF's performance to date has been dismal: it has restructured the debt of only six companies, worth less than US\$1 billion. The problem with the JITF has been its inability, in the face of political uncertainty and interference and a lack of government resolve, to address the issue of burden sharing between debtors and creditors.

The IBRA has become Indonesia's largest creditor since acquiring the failed banks. As a result, its asset-management unit has been active in restructuring viable loans and in foreclosing and disposing of other bad loans. At the end of March, 2000, 1,103 cases, accounting for US\$8.8 billion in foreign debt and Rp 630 trillion in domestic debt, were registered with the IBRA. These cases are at various stages of restructuring, ranging from initial negotiations to final payments. The IBRA has managed to sell stakes in ASTRA, the largest car maker, and in the Bank of Central Asia, which were some of the most attractive

assets. In a deteriorating business climate, however, the selling off of other less appealing assets has been difficult.

The INDRA serves as an intermediary between creditors and debtors and is meant to provide protection against foreign-exchange risk resulting from a rate of depreciation exceeding the inflation rate and to make foreign exchange available for payments. The scheme does not, however, provide either cash relief for debtors or incentives for creditors to adjust their loans, and it has been criticized as being too complicated.

The weak banking system has been one of the chief constraints on Indonesia's debt restructuring. Suffering from bad debts and undercapitalization, Indonesian banks have simply not had the resources or technical skills to manage the workout of corporate debts within the framework of the JITF. Steven Radelet (1999) argues that Indonesia's debt burden has become so large that the country will not be able to service it—in particular, the US\$36 billion owed to foreign banks—without significant relief from foreign creditors (including the Japanese).

At present, Indonesia's problem with corporate-debt restructuring is not to design a better institutional framework but to ameliorate the existing framework. This is apt to take a long time, however, given the large numbers of creditors and debtors; the complexity of the corporate-debt burden; the low level of trust in the system; inadequate bankruptcy mechanisms; the complex tax, legal, and regulatory frameworks; and the fragmentation among the institutions charged with restructuring (World Bank, 2000a). In the short run, the priority should be on restructuring state banks, improving financial supervision, and accelerating asset recovery. Equally critical is the necessity of consolidating existing institutions to facilitate out-of-court workout settlements and the strengthening of bankruptcy procedures.

One reason for the severity of the crisis in Indonesia was that the country's market, regulatory, and legal institutions were too weak to manage the crisis when it arose. Three years later, they are no stronger, and herein lies Indonesia's dilemma. Building and deepening institutions is, and perhaps should be, a medium-term objective, but without these institutions in place, the Indonesian authorities will continue to find it difficult to achieve the short-term goal of completing the operational restructuring of banks and corporations. To complicate the reform process further, the new coalition government that came to power in October of 1999 has found it difficult to maintain unity within its cabinet. This lack of unity has greatly undermined government support for the IBRA and other restructuring agencies. Certainly, the

government has failed to coordinate and compromise the interests of the various political entities participating in the coalition. This failure will continue to hamper further progress in financial and corporate restructuring.

### *Korea*

Immediately after the crisis began, the top priority in Korea was to restore market confidence to prevent bank runs and capital flight. Once the bleeding phase was over, the Korean authorities moved on to resolving insolvent financial institutions and to rehabilitating those that were weak but still viable. The financial-restructuring plan also included the adoption of international standards of regulation and supervision, as well as a scheme for capital-market development. Banks were required, for example, to adopt forward-looking criteria in evaluating the quality of their assets and to attain a minimum CAR of 10 percent before the end of 1999. Since early 1998, numerous actions have been taken for financial recovery:

- On April 1, 1998, the existing supervisory institutions for banks, nonbank financial institutions, securities, and insurance companies were consolidated to form the Financial Supervisory Commission (FSC). The FSC has since taken charge of implementing and coordinating policies for financial and corporate restructuring.
- On July 15, 1998, five insolvent commercial banks were closed and absorbed by healthier banks through a purchase and assumption scheme. Two banks, Korea First Bank and Seoul Bank, were recapitalized with public funds and de facto nationalized in early 1998. Korea First Bank has since been sold to a foreign consortium, but negotiations for the sale of Seoul Bank to the Hong Kong Shanghai Banking Association have been terminated. Korea's five largest banks have undergone mergers.
- Of the thirty merchant banks, sixteen have been closed, merged, or suspended, and the remaining fourteen are being closely monitored. The Hanaram bridge bank was created in late December 1998 to take over, manage, and liquidate the assets and liabilities of insolvent merchant banks.
- The government decided to mobilize W64 trillion (US\$49.2 billion—about 15 percent of GDP) for fiscal support for restructuring. Public funds have been provided through the purchase of bad loans by and through the Korea Deposit Insurance Corporation in the form of equity-capital injections. The corporation was established in April 1999.

- By the end of June 1999, the Korean Asset Management Corporation (KAMCO), which was reconstituted as an asset-management company, had purchased W46 trillion (US\$38.3 billion) in NPLs, paying for these assets at an average rate of 45 percent of face value.

Although KAMCO has so far sold only W5.8 trillion worth of the NPLs it acquired, most of the banks, including the restructured ones, have seen a substantial improvement in the quality of their assets and profitability of their operations. Their lending capacity has also increased, supporting the ongoing recovery of the economy. However, financial restructuring is far from over. The FSC has been struggling with the resolution and recapitalization of the three largest investment trust companies (ITCs), which hold many of the corporate bonds issued by insolvent corporations engaged in out-of-court workouts with their designated lead banks (including the Daewoo group). On November 4, 1999, the Korean government announced a reform plan for the investment trust industry, which includes:

- A W3 trillion injection of public funds to recapitalize Korea's two largest ITCs.
- A W18 trillion purchase by KAMCO, at market prices discounted by prevailing interest rates, of nonguaranteed bonds issued by Daewoo (Korea's third largest industrial group before its breakup).
- An allocation of W2 trillion in liquidity support for the two largest ITCs through the Korea Securities Finance Corporation.
- The introduction of tax-favorable high-yield junk-bond funds (gray funds) at ITCs.
- The purchase, without limit, of ITC bond holdings by the Bond Market Stabilization Fund to prevent the redemption by investors of their holdings of beneficiary certificates issued by ITCs.

The FSC has also sought to resolve and rehabilitate a large number of nonbank financial institutions, including life-insurance companies. Its efforts in this regard have been overshadowed, however, by the continuing problems of bad loans at the nation's major commercial banks in the aftermath of the collapse of Daewoo and other large industrial groups.

The Daewoo group defaulted on the payment of its debt (estimated to be US\$50 billion) in July and has since been subjected to a restructuring process negotiated with its creditor banks. In the interim, twelve Daewoo affiliates disclosed on November 4, 1999, that the value of their combined assets was W61.2 trillion but that their liabilities were

W86.8 trillion, revealing a negative net worth of as much as W26 trillion.

Korea's financial institutions were required to reschedule W31.2 trillion of their total exposure to the Daewoo units over an unspecified period of time through write-downs and debt-equity swaps. As a result of the rescheduling, the banks and other financial institutions may lose as much as 50 percent of the value of their rescheduled loans. The FSC, however, is confident that the banks have built up enough loan-loss provisioning to absorb potentially large losses on the Daewoo loans.

Despite the enormous losses Korea's financial institutions have had to sustain from the adverse repercussions of the Daewoo workout, the response of domestic as well as foreign investors to the Korean government's plan for Daewoo and ITC restructuring has been much more positive than anticipated. Although investors recognized the possibility of dislocation in several industries in which Daewoo was a major producer and exporter, they were encouraged by the government's workout plan, because it was going to pave the way for clearing the economy of Korea's debt-heavy industrial groups (*chaebol*).<sup>8</sup>

In addition to breaking up the Daewoo group, the government sought to improve the balance sheets of the top five *chaebol* by mandating that they lower their debt-equity ratios to 200 percent before the end of 1999. A booming stock market, strong earnings, and internal operational restructuring had helped these large industrial groups reduce their debt dependence in 1999. The sagging stock market and poor earning prospects since the second quarter of 2000, however, have prevented further improvement.

The slow pace of corporate restructuring has severely curtailed the ability of Korean banks both to meet the CAR requirement and to raise the amount of loan-loss provisioning needed to absorb the losses emanating from corporate workouts. To compound the problem, the growth outlook has been growing more pessimistic as the external environment has deteriorated. To prevent further impairment of bank balance sheets and to hasten corporate restructuring, the Korean government unveiled in September 2000 a plan for a second round of financial-sector restructuring that will require W40 trillion more than the W64 trillion it has already spent. In the face of renewed pessimism, however, the market's reaction to the second round has been much more negative than expected.

<sup>8</sup> *Chaebol* are large, diversified, industrial groups that are often family owned or controlled.

In reforming the corporate sector, the Korean government has taken a three-pronged approach. The five largest *chaebol* are restructuring under the Capital Structure Improvement Plans (CSIPs), which require that they (1) reduce their debt-equity ratios from 302 percent (at end-June 1999) to 200 percent by the end of the year, (2) eliminate existing cross guarantees between different subsidiaries in different lines of business, and (3) shed noncore businesses by exchanging their affiliate units with other *chaebol* (“big deals”). The sixth to sixty-fourth largest (“6–64”) *chaebol* and other large corporations have been subject to out-of-court workouts with their designated lead banks (London Approach).

Because small and medium-sized enterprises (SMEs) in Korea account for a relatively small fraction of banks’ outstanding loans, their restructuring has been somewhat neglected. Government efforts to date have focused on extending emergency loans of working capital to keep the SMEs from going bankrupt, thereby gaining time and preserving employment; an SME debt workout and operational restructuring, however, are urgently needed.

The restructuring of the big-five *chaebol*, as well as the workouts of smaller *chaebol* and other large corporations, have drawn mixed reviews since they were launched more than a year ago. As for the restructuring of the “6–64” *chaebol* at the end of June 1999, of the ninety corporations selected for a formal workout, forty-seven belonged to sixteen *chaebol* ranked between sixth and sixty-fourth in size. Eighty firms have reached agreements with their creditor banks on workout schemes.

In the workout process, the lead banks have been accused of being negligent in conducting due diligence of candidate firms for restructuring, because their plans have included many entities that should be liquidated. The banks cannot easily absorb additional losses, however, and so have been tempted to keep on their balance sheets many nonviable firms with the hope that at least some of these may be able to survive the crisis. At the same time, the lead banks have been unable to devise a comprehensive set of workout criteria involving debt-equity swaps, debt write-downs, and debt rescheduling.

For these reasons, the workout process has raised concerns about fairness, effectiveness, and the influence of political pressure and favors. It has been further complicated by disagreements about the appropriate level of loan-loss provisioning at the banks and by the resistance of the workout firms to the loss of management control. It is expected that a large number of restructured firms will fail to meet the obligations they negotiated with their lead banks.

As for the “big deal,” many of the proposed business swaps among the big-five *chaebol* have been mired in asset-valuation disputes. In fact, encouraged by the ongoing recovery, and by low interest rates and a bullish stock market, the big-five groups have been backtracking on their earlier promises; they now show little interest in improving corporate governance and in paring interests to a few core businesses, and they have even shown a fresh appetite for expanding into new enterprises.

### *Malaysia*

When Malaysia came under a speculative attack in July 1997, it, like its neighbors, shifted to a tight monetary and fiscal policy to defend its currency (the ringgit). Unlike Thailand and Indonesia, Malaysia was able to weather the initial attack for almost a year after the Thai crisis erupted. By mid-1998, however, it was clear that this initial policy response was not working. Faced with a deteriorating macroeconomic situation, Malaysia decided to fend for itself by taking radical measures of its own, rather than accepting an IMF rescue package.

Even before the crisis hit, Malaysia had developed more effective bankruptcy and foreclosure laws and had a stronger supervisory capacity than the other East Asian countries had. In addition, its precrisis banking sector was well capitalized, with an average CAR exceeding 10 percent.

Since May 1998, the Malaysian authorities have taken steps to build and consolidate an institutional framework for financial and corporate reforms. One component of the framework is Danaharta, an asset-management company established to acquire NPLs from banking institutions. Another institution, Danamodal, was created in July 1998 as a special agency to recapitalize financial institutions for which the CARs fall below 9 percent. A third, the Corporate Debt Restructuring Committee (CDRC), was established in August 1998 to facilitate the restructuring of corporate debt outside the courts through voluntary agreements between creditors and debtors.

Each of these organizations has made considerable progress. Danaharta has so far acquired approximately M\$45.5 billion in NPLs, or about 40 percent of the total NPLs in the financial sector. At the end of 1999, Malaysian banks held an additional M\$65.8 billion in NPLs on their balance sheets (about 20 percent of their total loans). Adding the NPLs acquired by Danaharta, the total NPLs accounted for more than 40 percent of GDP at the end of 1999. In addition, Danamodal has injected M\$6.4 billion into ten of the weaker but viable institutions. Initially, the Malaysian government planned to recapitalize twenty-



three financial institutions through Danamodal at a cost of about M\$16 billion, but the ongoing recovery has reduced the amount needed. As a result of this injection of government funds, the CAR of the banking system as a whole has risen to 13 percent.

The bank restructuring has increased the banks' capacity to absorb a substantial portion of the losses emanating from writing down or selling NPLs to Danaharta and has also enabled them to increase their lending operations, thereby placing them in a relatively more favorable position to address their remaining NPLs and corporate-workout problems. The Malaysian banks might also have taken advantage of the rapid recovery and strengthening of the capital market to raise new equity capital, thereby allowing for the sale of additional poor-quality assets and the absorption of additional losses. Like their counterparts in other crisis countries, however, they have been reluctant to dispose of their NPLs and to go to the capital market, largely because existing bank shareholders are not willing to sustain their investment losses and to accept a dilution of their equity in the banks. Nevertheless, with an adequate legal system and a well-structured institutional framework for financial restructuring in place, the prospects for Malaysia successfully carrying out the restructuring of its financial system are more promising than in either Indonesia or Thailand. Banks in Malaysia may well be able to recapitalize themselves using internal resources, with NPLs peaking at 20 to 25 percent of total loans (Claessens, Djankov, and Klingebiel, 1999).

Since July 1999, the Malaysian authorities have embarked on an ambitious plan to consolidate various financial institutions. It is hoped that this plan will both accelerate the pace of reform and make the financial sector more resilient and competitive. Responding to the worldwide trend of megamergers between banks and other financial institutions, the Malaysian government initially planned to consolidate the nation's fifty-eight financial institutions (twenty-one banks, twenty-five finance companies, and twelve merchant banks) into six large financial groups, each of which would consist of three large entities specializing in commercial banking, merchant banking, and finance-company operations, respectively.

Although the consolidation strategy may, in the long run, improve the efficiency and competitiveness of the financial sector, its implementation has been delayed by opposition from large stockholders of many of the targeted institutions as well as by technical problems related to their due diligence. The number of final groups has been raised to ten since the program was announced, and on February 2000, the government

granted charters to these groups and required them to complete the merger process before the end of September 2000. If accelerating the merger process reduces bank lending, however, it might delay the recovery, because bank borrowing at a relatively low cost has been one of the main features of Malaysia's recovery strategy.<sup>9</sup>

The precrisis corporate sector in Malaysia was stronger than in the other East Asian countries, with lower leverage and less exposure to foreign debt. Although Malaysian corporations were also hard hit by the rise in interest rates after the crisis erupted (because they were heavily dependent on bank financing), corporate distress has not been systemic and has been largely concentrated in real estate, construction, and infrastructure (in contrast to Korea, where it is concentrated in manufacturing).

Ailing corporations in Malaysia have been restructured through the bankruptcy courts and through out-of-court voluntary settlements between creditors and debtors assisted by the CDRC and Danaharta. In addition to the already existing market and legal remedies, including the CDRC, the government has established several other new institutions to deal with corporate restructuring. These include the Loan Monitoring Unit of the central bank, which is assisting small corporate borrowers with total outstanding debt of less than M\$50 million to receive financial support while restructuring their operations; a rehabilitation fund for small and medium-sized enterprises (SMEs), which was established in 1998 to help viable SMEs restructure; and the Finance Committee on Corporate Governance, in March 1998, for reforming corporate-governance practices.

As noted above, Danaharta has so far acquired approximately 40 percent of all outstanding NPLs in the financial sector. It was expected that these NPLs would be restructured fairly quickly. More than a year after its inception, however, Danaharta had managed to start selling only part of its foreign-loan assets, and only toward the end of 1999, did it sell its first foreclosed-property assets.

The CDRC has adopted a voluntary out-of-court settlement process between debtors and creditors. As of January 2000, sixty-seven companies, with debts totaling M\$36.3 billion, applied for debt restructuring with the CDRC. Of these, only nineteen restructurings have been completed, accounting for M\$14.1 billion. The pace has been slow, because the Danaharta-CDRC scheme focuses on debt restructuring

<sup>9</sup> The securities commission also plans to consolidate brokerage houses by reducing the current sixty-three houses to fifteen.

while setting aside the more critical problems of asset sales, mergers, and management restructuring of money-losing firms. Progress has also been hampered by the lack of technically trained staff.

Although the banking sector has been strengthened by the disposal of NPLs and by recapitalization, its lending operations have not expanded in tandem. This is partly because many sectors, and, in particular, the property sector, are still struggling with an excess of capacity. Faced with the shrinkage of bank lending, the Malaysian authorities have been debating whether to step up the operations of Danaharta and Danamodal to strengthen the banking sector further or to shift the focus of policy to resurrecting the economy while maintaining the current speed of bank restructuring. This question is analyzed in some detail in Section 5.

After deciding on September 1, 1998, to follow an independent course of action, the Malaysian government announced capital-control measures to halt the movement of short-term capital.<sup>10</sup> The ringgit was pegged to the U.S. dollar at the rate of M\$3.80 the very next day.

The immediate reaction to this reversal of the liberalization policies Malaysia had pursued and implemented during the previous two decades was clearly negative. It is interesting to note, however, that the regional markets showed more stability in the weeks following September 2 than they had before. One possible explanation for this stability is that the speculative attacks had eased and the currency and stock market had already stabilized by the time Malaysian authorities announced capital controls. Another explanation is that the IMF-designed policies in Indonesia, Korea, and Thailand had helped those countries recover from the worst phase of the crisis and that the consequent stability in the region may have had positive effects on the Malaysian economy.

On September 2, 1999, exactly one year after capital controls were imposed, the authorities in Malaysia decided to relax some of them. It is worth mentioning that the IMF's annual review of the Malaysian economy, released on September 10, 1999, acknowledged that the capital-control measures had helped in Malaysia's early economic recovery and that they had provided a "breathing space" in which the authorities could initiate and implement financial-sector restructuring and reforms.

<sup>10</sup> It is important to note here that the capital-control measures were meant to control short-term capital only. Capital movements in foreign direct investment (FDI), transactions for trade in goods and services, interest payments, profits, and dividends on long-term capital are not controlled by these measures.

### *Thailand*

As in the other crisis-affected countries, the Thai government's program for structural reforms addressed the resolution and recapitalization of financial institutions as well as institutional reforms such as the strengthening of bank supervision and improvement of corporate governance.

Three months into the crisis, the Thai government established the Financial Sector Restructuring Authority (FRA) and the Asset Management Company (AMC) to resolve the failed finance companies and dispose of their assets. In December 1997, the FRA closed fifty-six of the fifty-eight suspended finance companies. The liquidation of these companies' assets is now almost complete, and the FRA is in the process of adjusting creditor claims and distributing proceeds. Although the AMC was created as a bidder of last resort for the FRA assets, it remained dormant until March 1999, when for the first time, it purchased loans at an FRA auction. Nearly all of its assets, moreover, are real-estate loans. This, together with an inadequate legal system for loan collection, has severely restricted the AMC's loan-resolution operations.

Unlike the other crisis countries, however, Thailand was inclined to follow a market-based approach in resolving and recapitalizing banks and other nonbank financial institutions early in the crisis. The rationale for this strategy was that these institutions could be recapitalized by private investors if they were tightly supervised, were made more transparent, and were able to obtain fresh capital through a progressive introduction of a new and stricter loan-classification scheme and a gradual strengthening of provisioning requirements.

After a year of implementation, the Thai government realized that the market-led strategy was not effective. Private investors had little incentive to invest in banks and other financial institutions that were amassing large volumes of NPLs as a result of the continuing recession. The government therefore shifted to a more interventionist strategy. On August 4, 1998, it announced a new, comprehensive, financial-restructuring package, including the injection of public funds to recapitalize financial institutions, regulatory changes in the composition of the capital base, and the creation of individual, privately owned asset-management companies. If banks and other financial institutions were prepared to comply with a new loan-loss provisioning earlier than the targeted year of 2000, they were allowed to issue preferred stocks to the government in exchange for government bonds, which are counted as Tier 1 capital. These measures have been complemented by a

revision of the framework for the regulation and supervision of financial institutions designed to strengthen the Bank of Thailand's role and capacity as a supervisory institution in line with international standards.

At the end of 1999, the NPLs held by Thai commercial banks accounted for almost 40 percent of their total loans and had a negative net worth equivalent to 45 percent of their total assets. Although these NPLs are decreasing as they are written off by the banks, transferred to bank-owned asset-management companies, or restructured, they are being replaced in part by restructured loans reentering NPL status (about 17 percent of loans restructured in 1999 have failed to perform). The high NPL ratio has made it almost impossible for banks to recapitalize through earnings or through the issue of equities. Yet, the Thai bank owners have resisted the pressure to write down their capital in return for public funds, because they are determined to maintain ownership and control of their institutions. Only two banks have accepted the August 14, 1998, government scheme of recapitalization; most of the others have resorted to complex arrangements to raise capital, such as curtailing new lending and issuing preferred stocks linked with subordinated debentures.

In Thailand, as in other crisis countries in East Asia, a financial culture that relies on relationship banking, collateral, and trust, rather than on a more modern policy of risk management, has also delayed bank restructuring. At the same time, weak laws with respect to bankruptcy proceedings allow many nonpaying bank borrowers to stay out of bankruptcy court. This weakness in the legal system has made many borrowers resist a restructuring of their debt. The close relations between bank board directors and large defaulters also remain an obstacle. In many cases, the lender and defaulter are one and the same.

The policy of encouraging financial institutions to deal with bad debts by establishing their own asset-management companies, rather than by relying on a single national company, as in Korea, has been less than a success. The private companies have been plagued by technical and operational difficulties that have impeded negotiations with potential investment partners and thus hindered the restructuring process.

Thailand has been moving ahead of other crisis countries in liberalizing and opening the market for financial intermediation services. To date, four of Thailand's thirteen commercial banks have been sold to foreign entities. Although it is too early to draw conclusions, the enhanced foreign competition in the financial-services market has not yet provided incentives to domestic banks to improve their balance sheets and income statements through restructuring.

In contrast to the other crisis-affected countries, SMEs in Thailand account for more than two-thirds of the aggregate corporate debt. Because they are dispersed throughout the country and their loans are small in size, SME restructuring has been slow and difficult. The principal components of the Thai corporate restructuring are in providing tax and other incentives to corporations and banks, developing an effective legal framework for the recovery of debt through bankruptcy liquidation and reorganization, and creating the Corporate Debt Restructuring Advisory Committee (CDRAC) to facilitate an out-of-court process for negotiating debt restructuring.

Although some progress has been made, corporate restructuring has been a demanding and disappointing process. At the end of January 2000, the CDRAC had, under its restructuring program, targeted 6,210 debtors whose outstanding credit was almost equivalent to the total of bank NPLs. To date, only 211 debtors have reached workout agreements. In recent months, the CDRAC has been increasingly dealing with less viable and small firms, which require greater capacity for mediation and business restructuring. The CDRAC does not have this capacity.

Businesses in Thailand have resisted debt restructuring because they will sustain huge losses in any fire sale of unprofitable investments, and they will continue to resist so long as asset prices remain depressed. The traditional preference for debt financing, as opposed to equity financing, and insensitivity to maturity mismatching have also impeded the restructuring process. The mergers have been time-consuming and complicated, and procedural difficulties have, in many cases, blocked mergers that could facilitate corporate-debt restructuring.

At the same time, banks have preferred to reschedule debts, rather than to take losses from debt write-downs and debt-equity swaps, because many of the restructured corporations have not been able to service their loans. At large banks, for instance, 16 percent of the restructured loans became nonperforming again in 1999 under the new terms, because the continuing recession brought the level of cash flow below the level that had been projected at the time of restructuring.

Commercial banks have been unwilling to expand their lending operations, both because they are undercapitalized and, more important, for fear of inviting government intervention and losing ownership control should they run further losses. In this milieu, SMEs have been the primary victims of the scaling back of banks' lending operations. Thai banks have been inactive in restructuring the debts of insolvent SMEs, because it is costly to conduct due diligence of a large number of nontransparent SMEs scattered across the country. On August 10,

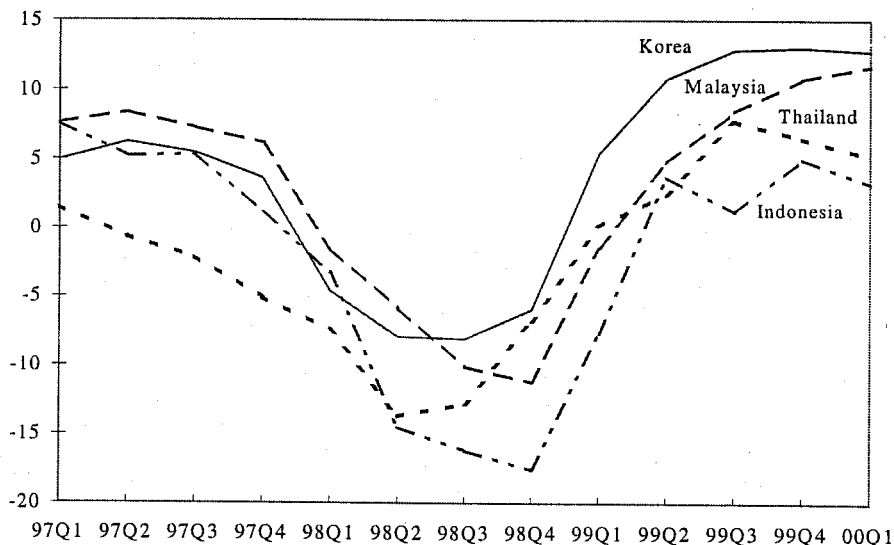
1999, in an effort to accelerate corporate recovery, the Thai authorities unveiled a new policy package designed to stimulate domestic investment. The package includes the establishment of a series of financial advisory centers to provide advice to SMEs on their operational and debt restructuring.

### 3 The Forces Driving the East Asian Recovery

#### *Financial and Corporate Restructuring and Recovery*

The experience of financial crisis in most countries suggests that it takes, on average, two to three years for an emerging-market economy to return to its precrisis trend rate of growth, and that growth rates thereafter do not rise above the precrisis level, so that GDP remains permanently below the precrisis trend (Lee and Rhee, 2000). As shown in Figure 1, however, the East Asian crisis countries have been able to bounce back in a V-pattern of adjustment after only a year and a half of severe recession. The Korean recovery, in particular, contrasts

FIGURE 1  
QUARTERLY GDP GROWTH RATES, 1997–2000  
(Percent)



SOURCES: Asia Recovery Information Center (<http://aric.adb.org/indicators/ino/peia.asp>); Asian Development Bank Regional Economic Monitoring Unit; IMF, *International Financial Statistics*, August, 2000.

sharply with the stylized patterns of adjustment, in that the initial GDP contraction and the subsequent recovery from it have been far larger than expected or than predicted by the cross-country evidence (see Table 3 and Lee and Rhee, 2000).

At the beginning of the East Asian crisis, it was widely believed that the crisis countries would have to commit to structural reforms in order to recover. The reforms were expected to help the region emerge from the crisis with more stable, transparent, and efficient financial and corporate sectors. This expectation of reforms espousing a market-oriented system would then improve long-term growth prospects and at the same time restore market confidence, thereby inducing the return of foreign lenders and investors to the region.

Three years into the reform process, the crisis countries have accomplished a great deal in improving the soundness and profitability of financial institutions and in alleviating corporate distress. The World Bank (2000b, p. 7) argues that “assertive structural adjustment helped restore credit flows and boosted consumer and investor confidence.” Yet, it is not clear whether and to what extent financial and corporate restructuring has contributed to the ongoing recovery. Most of the serious structural problems that were identified as the leading causes of the crisis in Indonesia, Korea, Malaysia, and Thailand could not have been resolved over a span of two years. In fact, banks in all four countries are still holding large volumes of NPLS on their balance sheets and remain undercapitalized (Table 1); many corporations in the region are still unable to service their debts. As for institutional reform, new banking and accounting standards, new disclosure requirements, and new rules for corporate governance have been introduced, but they are not rigorously enforced. It will take many years for the new system to take root.

Because the crisis countries are not yet halfway through the process of restructuring their financial institutions and corporations, it would be presumptuous to argue that the reform efforts have established a foundation for sustainable growth in East Asia. It would also be inappropriate, at this stage, to assert that the efficiency gained through restructuring has been a principal factor driving the recovery.

The available evidence also fails to support the contention that the market-oriented reform has contributed to restoring market confidence in the East Asian crisis countries; it certainly does not appear to have done so during the first two years of the crisis. International credit-rating agencies report that the reforms in the banking sector in the crisis countries are not yet sufficient to ensure that these economies



TABLE 3  
MACROECONOMIC AND POLICY INDICATORS, 1993-2000  
(Percent and percent growth, year to year)

	1993	1994	1995	1996	1997	1998	1999	2000/Q1
INDONESIA								
Annual Macroeconomic Indicators								
GDP growth rate		7.5	8.2	7.8	4.7	-13.0	0.3	3.2
Gross domestic investment index (1996 = 100)				100.0	106.3	58.7	50.7	39.3
Private consumption expenditure growth rate	11.8	7.8	12.6	10.9	6.7	-3.3	0.5	1.8
Export growth rate	8.4	8.8	13.4	9.7	7.3	-8.6	-0.4	39.0
Current-account balance as percent of GDP	-1.3	-1.6	-3.2	-3.4	-2.3	4.1	3.5	—
Inflation growth rate	9.7	8.5	9.4	8.0	6.2	58.4	20.5	—
Annual Policy Indicators								
Government expenditure index (1996 = 100)	98.2	103.5	102.5	100.0	110.4	85.4	—	—
Fiscal balance as percent of GDP				1.2	-0.7	-1.9	-2.3	—
Annual real bank credit index	55.5	67.8	82.7	100.0	128.5	172.1	80.8	—
Domestic credit		22.9	21.7	22.7	25.7	53.7	21.4	46.4
KOREA								
Annual Macroeconomic Indicators								
GDP growth rate		8.3	8.9	6.8	5.0	-6.7	10.7	12.8
Gross domestic investment index (1996 = 100)				100.0	92.5	57.0	74.3	73.6
Private consumption expenditure growth rate	5.6	8.2	9.6	7.1	3.5	-11.4	10.3	11.2
Export growth rate	7.7	15.7	31.2	4.3	4.8	-2.8	8.6	-17.7
Current-account balance as percent of GDP	0.3	-1.0	-1.7	-4.4	-1.7	12.7	6.1	—
Inflation growth rate	4.8	6.3	4.4	4.9	4.4	7.5	0.8	—
Annual Policy Indicators								
Government expenditure index (1996 = 100)	70.1	79.8	88.0	100.0	114.7	123.5	—	—
Fiscal balance as percent of GDP				-1.7	-4.4	-3.5	—	—
Annual real bank credit index	61.2	73.0	83.8	100.0	121.2	131.4	157.4	—
Domestic credit		18.5	14.6	19.4	23.2	11.6	17.4	16.2

## MALAYSIA

## Annual Macroeconomic Indicators

GDP growth rate	9.2	9.8	10.0	7.3	-7.4	5.6	11.7
Gross domestic investment index (1996 = 100)			100.0	111.2	63.4	60.3	48.6
Private consumption expenditure growth rate	6.3	9.4	6.9	4.3	-10.8	3.1	14.4
Export growth rate	16.0	23.3	26.3	7.1	-6.2	15.7	21.9
Current-account balance as percent of GDP	-4.5	-6.1	-9.5	-4.7	13.0	9.0	—
Inflation growth rate	3.6	4.9	4.1	3.5	5.3	2.7	—
Annual Policy Indicators							
Government expenditure index (1996 = 100)	80.8	85.1	89.7	100.0	95.1	—	—
Fiscal balance as percent of GDP			1.1	2.4	-1.5	-3.5	—
Annual real bank credit index	56.1	64.7	83.4	100.0	126.2	129.9	—
Domestic credit	14.8	29.5	31.2	29.3	-2.7	0.3	—

## THAILAND

## Annual Macroeconomic Indicators

GDP growth rate	9.0	8.9	5.9	-1.7	-10.2	4.2	5.2
Gross domestic investment index (1996 = 100)			100.0	76.9	39.0	44.0	65.3
Private consumption expenditure growth rate	8.4	7.9	7.6	-1.1	-12.3	2.9	5.0
Export growth rate	13.7	22.1	24.7	-1.9	-6.8	7.4	29.3
Current-account balance as percent of GDP	-5.1	-5.6	-8.1	-1.9	12.5	8.9	—
Inflation growth rate	3.3	5.2	5.7	5.8	8.1	0.3	—
Annual Policy Indicators							
Government expenditure index (1996 = 100)	73.6	77.7	81.6	100.0	89.9	—	—
Fiscal balance as percent of GDP			1.0	-1.7	-3.7	—	—
Annual real bank credit index	75.5	83.6	92.3	100.0	113.8	112.2	—
Domestic credit	29.4	23.0	14.0	34.5	-1.3	-4.2	-2.7

SOURCES: Asia Recovery Information Center (<http://aric.adb.org/indicators/ino/peia.asp>); Asian Development Bank Regional Economic Monitoring Unit; IMF, *International Financial Statistics* (August 2000).

can forestall another financial crisis. It was only toward the end of 1999, that Moody's and Standard & Poor's upgraded the sovereign credit ratings of Korea and Malaysia from speculation grade to the lowest investment grade (Table 4). By that time, the recovery was in full swing in East Asia. Journalistic accounts have continued to raise doubts about the effectiveness of the reforms in the crisis countries, and numerous publications by the World Bank and the IMF stress the need for these countries to step up the pace of financial and corporate restructuring. Under these circumstances, one might suppose that most foreign investors would find it too risky to return to the crisis countries. Investors have returned, however, many of them lured back by the rapid recovery and the substantial improvement in the external liquidity position resulting from large surpluses on the current account.

Although capital inflows to East Asia have been rising, they are still well below the precrisis level. The international banks and global institutional lenders seem to have neither the patience nor the ability to monitor and assess the long-term effects of structural reforms, particularly when they are preoccupied with the short-term performance of their portfolios.

#### *Engines of Recovery*

A close examination of quarterly rates of GDP growth in the region shows that both Korea and Thailand reached the trough as early as in the second quarter of 1998, with Malaysia and Indonesia following two quarters later (Figure 1). Overall, the recession in East Asia bottomed out in the second half of 1998, less than a year after the crisis had begun. The current recovery in East Asia has been led mostly by a surge in consumption and export earnings stimulated by lower interest rates and fiscal expansion during the first quarter of 1999 (Table 5). By the middle of 1999, the ratio of consumption to GDP had returned to precrisis levels in all four crisis countries.<sup>11</sup> Fixed investment, however, shows no sign yet of rebounding in Indonesia, Malaysia, and Thailand.

If the restructuring efforts cannot be credited with the recovery and may not even have triggered the upswing, what factors and developments have buttressed the ongoing recovery, particularly in Korea? An answer to this question would require an empirical study gauging the relative importance of a number of potential factors, but the data

<sup>11</sup> In Indonesia, the ratio had risen by more than 10 percentage points, to 73 percent, by 1999.

TABLE 4  
SOVEREIGN-CREDIT RATINGS, 1997–2000

	Moody's	Standard & Poor's	Fitch IBCA
Indonesia			
January 9, 1998	B2	—	—
January 21, 1998	—	—	B+
March 11, 1998	—	B-	—
March 16, 1998	—	—	B-
March 20, 1998	B3	—	—
March 30, 1998	—	CCC+	—
Korea			
February 18, 1998	—	BB+	—
April 9, 1998	Ba1	—	—
January 19, 1999	—	—	BBB-
January 25, 1999	—	BBB-	—
February 12, 1999	Baa3 (positive)	—	—
August 23, 1999	Baa3	—	—
March 30, 2000	—	—	BBB+
Malaysia			
September 15, 1998	—	BBB-	—
December 3, 1998	Baa3	—	—
April 26, 1999	—	—	BBB-
November 10, 1999	—	BBB	—
December 7, 1999	—	—	BBB
July 12, 2000	Baa3	—	—
Thailand			
October 24, 1997	—	BBB	—
December 21, 1997	Ba1 (positive)	—	—
January 8, 1998	—	BBB-	—
May 14, 1998	—	—	BB+
June 24, 1999	—	—	BBB
April 3, 2000	Ba1	—	—
June 21, 2000	Baa3	—	—

SOURCE: Bloomberg.

NOTE: Moody's: Baa bonds are considered medium-grade obligations. Interest payments and principal security appear adequate for the present. Ba bonds are judged to have speculative elements, their future cannot be well assured. B bonds generally lack characteristics of the desirable investments. Standard and Poor's: BBB bonds have adequate protection parameters, but adverse economic conditions could lead to weakened repayment capacity. BB bonds have a speculative element. B bonds are more vulnerable to nonpayment than BB bonds. CCC bonds are currently vulnerable to nonpayment. Fitch IBCA: BBB bonds are investment grade, good credit quality bonds. BB bonds are speculative with a possibility of credit risk developing. B bonds are highly speculative, with a significant credit risk.

TABLE 5  
 QUARTERLY MACROECONOMIC INDICATORS, 1997-2000  
 (Percent and percent growth, year to year)

	97Q1	97Q2	97Q3	97Q4	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1
INDONESIA													
GDP growth rate	7.5	5.2	5.3	1.1	-3.3	-14.5	-16.2	-17.6	-7.7	3.7	1.2	5.0	32.0
Private consumption expenditure growth rate	—	—	—	—	4.0	1.9	-7.2	-11.0	-3.4	-2.0	5.7	2.1	1.8
Gross domestic investment growth rate	—	—	—	—	-34.0	-54.9	-46.2	-44.3	-30.3	10.8	-14.7	-11.3	-17.6
Export growth rate	10.4	7.1	9.4	2.4	0.9	-8.0	-8.9	-16.8	-18.8	-4.7	5.6	17.1	39.0
Domestic credit growth rate	—	—	—	—	—	—	—	—	—	—	—	—	—
Money market rate	12.1	13.6	44.5	41.1	57.9	66.3	74.2	52.8	39.9	28.9	13.2	12.2	9.5
Lending rate	18.9	18.7	23.4	26.2	26.3	32.2	34.9	35.2	34.1	30.3	24.5	21.7	19.6
KOREA													
GDP growth rate	4.9	6.2	5.5	3.6	-4.6	-8.0	-8.1	-5.9	5.4	10.8	12.8	13.0	12.8
Private consumption expenditure growth rate	4.5	4.4	5.3	-0.1	-11.6	-13.0	-12.3	-8.9	6.7	10.3	12.1	12.1	11.2
Gross domestic investment growth rate	3.0	-4.8	-11.9	-13.3	-49.0	-43.1	-40.6	-23.3	26.6	32.8	37.3	26.1	30.6
Export growth rate	-5.6	7.1	15.6	3.5	8.4	-1.8	-10.8	-5.5	-6.1	2.5	15.1	22.7	-17.7
Domestic credit growth rate	—	—	—	—	—	—	—	—	—	—	—	—	—
Money market rate	11.9	12.2	12.4	16.4	23.9	18.6	10.2	7.2	5.7	4.8	4.8	4.8	5.0
Lending rate	11.4	11.4	11.6	13.1	17.3	16.9	14.8	12.1	10.7	9.4	8.9	8.6	8.7

	MALAYSIA												
GDP growth rate	7.6	8.4	7.2	6.1	-1.6	-5.9	-10.1	-11.2	-1.4	4.8	8.5	10.8	11.7
Private consumption expenditure growth rate	2.6	6.7	6.4	2.0	-5.4	-8.9	-14.9	-13.8	-5.2	3.1	7.4	8.0	14.4
Gross domestic investment growth rate	6.1	32.4	13.6	-7.9	-17.3	-49.0	-50.9	-50.5	-26.4	-7.4	0.8	27.9	12.4
Export growth rate	7.6	0.4	2.7	-4.3	-10.7	-8.7	-10.9	6.5	5.2	15.6	21.8	18.9	21.9
Domestic credit growth rate	—	—	—	25.7	17.0	8.9	3.6	-0.3	-2.7	-2.6	-0.1	0.2	—
Money market rate	7.0	8.2	7.8	7.4	9.6	9.9	8.4	5.9	5.3	3.1	2.6	2.6	2.6
Lending rate	9.2	9.3	9.6	9.9	11.2	12.2	10.9	8.2	8.0	7.4	6.9	6.8	6.8
	THAILAND												
GDP growth rate	1.4	-0.7	-2.2	-5.1	-7.5	-13.7	-12.8	-6.8	0.2	2.5	7.8	6.5	5.2
Private consumption expenditure growth rate	8.4	2.9	-5.5	-9.5	-12.3	-17.1	-13.7	-5.4	-3.2	1.6	6.4	7.4	5.0
Gross domestic investment growth rate	-11.3	-20.6	-23.6	-36.0	-43.2	-67.3	-54.3	-28.0	-4.9	44.3	11.9	12.9	18.5
Export growth rate	-1.0	2.2	7.1	6.7	-2.9	-5.3	-8.7	-9.9	-4.2	5.7	10.9	17.1	29.3
Domestic credit growth rate	—	—	—	17.1	9.0	11.1	2.7	-1.4	1.3	-4.1	-6.9	-12	—
Money market rate	11.3	11.9	19.3	15.7	20.6	18.0	9.6	3.8	2.7	1.5	1.5	1.4	2.1
Lending rate	13.0	12.8	13.9	14.9	15.3	15.3	14.8	12.3	10.2	8.9	8.6	8.3	8.0

SOURCES: Asia Recovery Information Center (<http://aric.adb.org/indicators/ino/peia.asp>); Asian Development Bank Regional Economic Monitoring Unit; IMF, *International Financial Statistics* (August 2000).

and information required for such an analysis are not available, and the adjustment process in the crisis countries is far from over. At best, one can make a qualitative assessment of the effects of various factors on the recovery.

*Macroeconomic-policy adjustment.* Jong Wha Lee and Changyong Rhee (2000) show that the swift change in the macroeconomic policy stance toward expansion helped engineer a quick recovery in Korea (where relaxation of monetary and fiscal policy began in April 1998). There are similar studies for the other crisis countries, but a comparison of the turning points in the adjustment process, identified by annual growth rates of quarterly GDP (Table 5), with the timing of policy changes (Appendix A) confirms that the easing of monetary and fiscal policy has quickened the pace of recovery in both Malaysia and Thailand. Thailand shifted to a modest relaxation of macroeconomic policy in June 1998, and its economy took off in the fourth quarter of 1998 (after zero growth in the third quarter). Malaysia relaxed monetary and fiscal policy at the end of August 1998 when a relaxation of monetary and fiscal policy was announced in Malaysia, and its economy moved out of the trough a quarter later. Because Indonesia maintained a contractionary macroeconomic policy until the second quarter of 1999, in response to the continuing weakness of the rupiah, it is more difficult to establish any causality between policy changes in Indonesia and growth.

The V-pattern of recovery in East Asia also raises the question of whether the initial tightening of monetary and fiscal policy was too harsh and too prolonged, causing a deepening of the crisis, particularly in countries where firms were highly leveraged. Given the level of leveraging, the high-interest-rate policy may have increased the risk of business failures, thus causing the nominal exchange rate to depreciate, rather than to stabilize (Furman and Stiglitz, 1998; Radelet and Sachs, 1998b).

*Openness, export orientation, and flexibility.* An important structural factor driving the speedy adjustment in the crisis countries may have been their flexibility and openness. Because they had a relatively large trade sector and were oriented toward exports, these economies benefited from a large depreciation of the real exchange rate and a substantial fall in real wages. Lee and Rhee (2000) suggest, in addition, that because these particular economies are more private-sector oriented than are other emerging-market economies, they were able to manage a sharp decrease in consumption and investment. Their labor markets also proved to be less rigid than had been assumed. In adjusting to the financial shock, the labor markets were able to accommodate a large

drop in real wages in 1998, ranging from 10 percent in Korea to almost 50 percent in Indonesia, adjustments that many countries might find difficult to manage. Together with real depreciation, this large decrease in real wages has contributed to improving the competitiveness of exports and has thereby paved the way for recovery.

*Market perceptions of the crisis.* Another factor that might explain both the initial large contraction and the swift recovery relates to changes in the expectations of foreign investors and domestic households and firms about the economic prospects of the crisis countries. Immediately after the crisis, many thought that the crisis countries might be unable to avoid foreign-debt default and might have to declare a debt moratorium. In addition, the international financial community, including the international financial institutions, were quick to lay the blame for the crisis on the East Asian countries themselves. The emerging consensus that the crisis countries had profound, previously unrecognized, problems severely damaged their prospects for recovery. Many questioned whether these countries had the institutional capacity and political will to carry out the necessary structural reforms. Even if they had, the skeptics argued, they would take many years to put their houses in order. Under these circumstances, it is quite possible that the domestic households and firms, as well as the foreign investors, came to believe that the crisis was a permanent shock that would lead to a new equilibrium that was lower in terms of output and employment than would occur with a temporary shock. This perception of permanency may well have induced domestic consumers and investors to reduce their spending during the first six months of the crisis far more than they might otherwise have done.

Beginning in 1998, however, the criticism of East Asia gradually gave way to the realization that the crisis might, in fact, be temporary. In Korea, the turning point came in February 1998, when the leading foreign creditor banks agreed to lengthen the maturities of Korea's short-term foreign-currency loans.<sup>12</sup> Once at least some of the foreign credit facilities (including trade credit) were restored, the fear of debt default abated considerably.

In Malaysia, the government's decision, on September 1, 1998, to impose capital controls and to peg the ringgit to the U.S. dollar triggered the economy's fourth-quarter turnaround. Contrary to expecta-

<sup>12</sup> They did not do so voluntarily but, rather, at the urging of the G-7 governments and the IMF, and only when they were convinced that they would be repaid with handsome returns.



tions, Malaysia's decision not only did not disrupt the domestic or regional financial markets, but it seems to have ignited the ongoing recovery.

In Indonesia, the resignation of President Suharto and the formation of an interim government headed by Mr. Habibie in May 1998 seems to have set in motion a modest upswing (see Appendix A). A similar turning point cannot be easily identified for Thailand, although one might conjecture that the shift to a more expansionary policy in June 1998 may have supported the robust recovery beginning in the fourth quarter that year.

#### **4 Structural Reform: An Assessment**

Despite continuing pressure on the crisis countries by international financial institutions, the pace of reform has slowed considerably and, since early 2000, has even backtracked in some cases. This reversal can be attributed to mounting domestic opposition and to the indifference to and disregard of the reform progress by foreign-market participants operating out of East Asian financial markets.

The World Bank and IMF maintain that only a decisive and accelerated pace of restructuring can ensure medium-term durable growth (Fischer, 1999; Lane et al., 1999; World Bank, 2000b, chap. 7). Their message is that additional structural reforms must be implemented even if they act as a drag on recovery in the short run. Many critics of the IMF, including Feldstein (1998), Radelet and Sachs (1998a), Sachs (1998), and Veneroso and Wade (1998), however, write that the IMF programs were so misguided and inappropriate that they could not work. The experience of the crisis countries over the last two years seems to support this argument. This section discusses some of the institutional and other constraints that may have limited the effectiveness of the IMF programs in East Asia and that point to the need to readjust the current reform strategy.

##### *Dismantling the East Asian Model*

After the crisis broke out, the East Asian crisis countries were forced to eschew a development model that had promoted industrialization and raised living standards for almost three decades. Although they have been encouraged to substitute an Anglo-American market-oriented system or a system based on the Washington Consensus, East Asian policymakers, as well as the general public remain confused and unconvinced that the change is advisable. As Joseph Stiglitz (1999, p. 3) points

out, despite the crisis that beset the region, “East Asia remains the best model of development the world has probably ever seen. . . . [Furthermore], the East Asian miracle was real and was based on a set of sound fundamentals and public policies.” Perhaps East Asia was no more vulnerable to crisis and no more afflicted by institutional weaknesses than were other regions.<sup>13</sup>

A case in point is the *chaebol* reform in Korea. The Korean authorities have been pressured to break up the *chaebol*, the dominance of which has been singled out as one of the leading institutional weaknesses of the Korean economy. A recent study, however, argues that because these groups “substitute for the institutions that support effective markets in capital, labor, and goods and services,” their rapid dismantling could create an institutional void and thus weaken the competitiveness of Korean companies (Khanna and Palepu, 1999, p. 125). If the dissolution of Korea’s industrial groups is deemed desirable for efficiency, the reform programs should at least have identified a new kind of industrial organization that could replace the *chaebol* system.

The bank-dominated financial system has also often been blamed for the crisis. All the IMF programs, therefore, have included a capital-market development plan. As the discussion in Appendix B suggests, developing a more balanced financial framework, in which capital markets complement and substitute for the banking system as a source of corporate financing, is undoubtedly a reform objective. It can be only a long-term priority, however, particularly because it is not altogether clear that the bank-dominated system is as serious a weakness as has often been claimed, and it cannot be replaced by a market-oriented system overnight.

Perhaps the most confusing accusation is that the high saving and investment rates in East Asia were damaging, because much of the money was wasted (“Frozen Miracle,” *Economist*, March 7, 1998). Among the many economic successes of East Asia before the crisis, the continued increase in the saving and investment rates was held up as an example to be emulated by other developing countries. A World Bank study in 1993 and many others, including that by Stiglitz in 1996, also provide empirical evidence that a growing volume of domestic saving, together with foreign-capital inflows, was channeled into efficient investment, mostly in manufacturing.

<sup>13</sup> Many of the structural characteristics and policies that were known to have contributed to East Asia’s rapid growth before the crisis were subsequently advanced as the weaknesses of the East Asian model (Furman and Stiglitz, 1998).

A surge in investment spending (partly supported by foreign borrowings) during the three years preceding the crisis seems to have alarmed no one, although it resulted in a large unused manufacturing capacity in Korea, contributed to speculative bubbles in the East Asian real-estate market in general, and led, eventually, in all four crisis countries, to a large increase in the current-account deficit as a proportion of GDP. Despite these ominous developments, no one, including the IMF, sounded the alarm, because they believed that, except in Thailand, the current-account deficits were within a manageable range.

Immediately after the World Bank's (1993) *East Asian Miracle* study was published, a number of total-factor productivity (TFP) studies began questioning the efficiency of the East Asian economies. At the time, the international policy community was skeptical about the reliability of these studies, because they were subject to conceptual as well as measurement problems. The dominant view was that the region could not have grown as fast as it had if the TFP estimates were as low as they appeared to be (Stiglitz, 1996).

After the crisis, however, despite the fact that TFP is known to be an unreliable measure of productivity gains, the results of the TFP studies were brought up again as evidence of how inefficient these economies had become as a result of cronyism, market rigidities, and protectionism. Armed with these results, the IMF has actively recommended that the crisis countries and other emerging-market economies rely more on productivity increases to spur growth and less on capital accumulation, because "recent experience [has] demonstrated the risks of relying on rapid increases in capacity to spur growth since it often results in unsustainable rates of capital accumulation and unhealthy debt levels . . . [and] with the increased globalization of capital and product markets. . . . Asian economies should seek to spur growth by promoting productivity improvement. . . . [This] means more open and freer financial, goods, and labor markets as well as liberal trade and exchange rate systems, . . . a move toward a new market-oriented model" (Fisher, 1999, p. 3).

The message of this recommendation is not clear, however. The rates of investment of East Asian countries have been high largely because their saving rates have been high. Is the IMF recommending that the crisis countries save less than before and abandon all of their incentives and institutional devices to promote saving? Or is it suggesting that the East Asian economies should continue to run sizable surpluses on their current accounts so as to augment their holdings of foreign-exchange reserves as a means of preventing future crises? Is

the IMF suggesting that a Washington Consensus view of reforms will assure financial-market stability and robust, sustainable, growth?

### *Institutional Weaknesses*

As discussed in Section 2, institutional weaknesses in the East Asian crisis countries have been the primary obstacle to a swift and efficient implementation of the IMF programs. This has been particularly true in Indonesia and Thailand. Long accustomed to rapid growth accompanied by financial stability, these countries had failed to develop a social infrastructure (government and market institutions and legal system) and the skilled manpower necessary for financial restructuring and corporate-debt resolution. Since the early 1990s, the crisis countries have made great strides in both market liberalization and political democratization. They have not, however, been able to develop many of the institutions needed to make their markets perform adequately.

Dani Rodrik (2000) identifies five kinds of market-supporting institutions: property rights; regulatory bodies; social insurance; conflict management; and macroeconomic stabilization. Of these, the absence of institutions for social insurance and conflict management has been most conspicuous in the crisis countries. After almost a decade of liberalization, East Asian central banks still remain subservient to the governments in power, and fiscal institutions are unable to deflect political pressure. Until the shift toward democratization and market liberalization in the early 1990s, conflicts among different interest groups, and, to some extent, the regulation and provision of social insurance, had been managed by the East Asian mechanism of coordination and cooperation among the government, the firms, and the banks. As political and economic liberalization progressed, the coordination and cooperation mechanism literally broke down, but it has yet to be replaced by market-supporting institutions.

The crisis countries were forced almost overnight to liberalize, to open their markets, and to graft onto their economies a host of new Western-based market institutions. Three years after the changes were introduced, many of them are either ignored or only carelessly enforced. Because these Western-based reforms have disregarded local customs and constraints, they have had little effect.

As part of the reform, all of the crisis countries have established an elaborate institutional framework for financial and corporate restructuring. In the absence of trained staff, experience, and, most of all, governmental commitment, however, they have been unable to make the new system function. The administrative work of closing finance

companies and banks in Indonesia and Thailand, for example, would ideally require 5,000 persons in each country, many of whom should be experts in bank restructuring. In addition, the new accounting system, although it conforms to international standards, has been hampered by a lack of trained and experienced accountants. When irregularities or violations of the new rules by inexperienced or corrupt accountants or accounting firms are discovered, the regulatory authorities have quickly revoked the licenses of the guilty parties. Although such a harsh penalty may be necessary to ensure strict compliance with regulations, it may make the situation worse by reducing the already inadequate number of licensed accountants.

Western corporate governance has also so far failed to take root in East Asia. Although large firms in East Asia, including the *chaebol* in Korea, are now required to appoint outside directors and to listen to minority shareholders, a few family members continue to make all corporate decisions. East Asia's powerful families remain determined to retain control of their businesses, as though giving up control is like losing face. Unless attitudes in the region change, the Western style of corporate governance is likely to remain countercultural in East Asia for many years to come ("South Korea's Unreformed Chaebol," *Economist*, July 22-28, 2000).

Finally, bureaucratic entrenchment has been a serious barrier to institutional reform. Even after the crisis, for example, the economic-policy leadership in the crisis countries did not change. In fact, those same policymakers, long accustomed to an interventionist regime (and presumably responsible for the crisis) have been entrusted with restructuring and reforming their financial and corporate sectors and with liberalizing and opening the domestic markets. It is not surprising that they have not fully understood either the need or the urgency for reform.

## **5 A Blurred Road Map for the IMF Programs**

As the IMF report (Lane et al., 1999) admits, the reform programs for the crisis countries had, from the outset, no road map other than the general policies of the Washington Consensus to guide the formulation and implementation of restructuring in East Asia.. The IMF should not be criticized after the fact for its failure to develop a comprehensive framework, however. With the crisis deepening every day and threatening the total collapse of the crisis countries, the IMF did not have the luxury of spending many months designing a coherent program. The program packages were designed to promote various reform measures

that would simultaneously restore market confidence, reduce the likelihood of a recurrence of crisis, and improve the long-term economic performance of these countries; little thought was given to possible conflicts among the different reform objectives.

Even with a well-conceived plan, a complicated program such as IMF conditionality, which included a wide range of measures for short-term operational restructuring as well as medium-term institutional reform, was bound to encounter difficulties. There has been considerable confusion about the appropriate targets for restructuring, inconsistencies between different reform measures, and the wrong sequencing of financial and corporate restructuring. In the end, this confusion has weakened the IMF programs. Some of the problems created by the IMF's blurred road map are discussed below.

#### *Setting Operational Reform Targets*

Because the IMF programs had not anticipated the sharp downturn in the regional economy, the massive currency depreciations, and the full extent of the financial and corporate-sector problems, the reforms had to be implemented reactively and to be modified as new information about their effectiveness and the depth of the problems became available (Lane et al., 1999). In such a reactive process, it was difficult to define and maintain the strategy and operational targets necessary for successful restructuring and institutional reforms or to obtain prior consensus for their implementation. The process, which had to be repeatedly adjusted, therefore raised the fundamental question of what would constitute realistic targets for the restructuring and reforms necessary to reduce the vulnerabilities of the crisis countries in terms of bank capital adequacy, the volume of NPLs, and loan provisioning. Financial reformers, for instance, could not agree about whether the operational definition of NPLs should include all loans that were overdue for more than three months or whether it should eschew the old mechanical classification in favor of a set of new forward-looking criteria. In the end, although the crisis countries adopted an international best practice of forward-looking criteria, the new loan classification has made it no easier to determine what constitutes a reasonable level of NPLs and, thus, the amount of public funds needed for their resolution.

The rationale behind the reform mandate by which banks in the crisis countries were required to raise their Bank for International Settlement (BIS) ratios to over 10 percent and by which large corporations in Korea were required to lower their leverage below 200 percent

before the end of 1999 was never made clear. Immediately after the crisis broke out, it was agreed that insolvent financial institutions must be closed, and many were suspended or liquidated. The programs did not state, however, whether it was desirable to close all of the money-losing institutions at once or whether they should be closed in some sequence. The programs also failed to state which types of institutions, new or old, should replace these liquidated institutions, so that the payment system and credit flow would be maintained and existing customers served (and the large number of skilled professionals shed by the failed financial institutions reemployed).

Confusion and dissension about target setting, and the consequent frequent changes in implementation strategies, have provoked strong resistance from the groups affected and have created uncertainties in the domestic financial markets about the pace and extent of reform required. To many foreign-market participants, these changes in strategy have been viewed as evidence that domestic policymakers are backtracking.

#### *Conflicts between Reform Objectives*

By following the reactive process of implementation, the IMF authorities may not have adequately considered whether the prescribed reforms were appropriate or consistent with one another. The following cases are examples:

- The reform programs were initially designed to restore market confidence and to develop the strong institutional foundation requisite for durable growth in the medium term. However, the completion of operational restructuring (resolution and recapitalization of financial institutions and corporate-debt workout) and institutional reforms does not automatically guarantee recovery and resumption of growth. As the experiences of crisis countries elsewhere suggest, restructuring and reforms might deepen economic downturn in the short run, unless they are complemented by expansionary macroeconomic policies. In all of the East Asian crisis countries, policymakers have found it difficult to decide when reflation of the economy should begin and what monetary and fiscal instruments should be used.
- The IMF reform programs appear to have underestimated the seriousness of the possible conflicts between operational restructuring of financial institutions and corporations, on the one hand, and institutional reforms, on the other. For example, the programs for Indonesia, Korea, and Thailand saw the need to upgrade loan classification, loan-loss provisioning, and capital adequacy at banks, but they did not carefully examine whether the planned regulatory upgrading could be

completed within a three-year period and whether and to what extent it might disrupt the recovery process. In many cases, while banks were trying hard to reduce their exposure to weak but viable borrowers, the policy authorities were busy providing special credit facilities and credit guarantees to the same borrowers.

- The injection of public funds into banks for recapitalization led to government ownership of a growing share of corporate assets, banks, and other nonbank financial institutions. Whether intended or not, this was clearly against the spirit of the IMF programs, which essentially espouse a market-led approach in financial and corporate restructuring. By mid-1999, the governments had amassed a large share of banking assets, ranging from 18 percent in Malaysia to 78 percent in Indonesia (World Bank, 2000b). No one had thought about how to deal with this nationalization problem beforehand and no one knows how, to whom, and at what prices these assets will be sold in the future. Because privatization of financial institutions is often a lengthy process, the pervasiveness of government in restructuring has raised the concern that the crisis countries may return to their old dirigist regimes.

- In the IMF programs, many of the institutional reforms, including the reform of government bureaucracy and the legal system, were prescribed as medium-term priorities to win back the confidence of foreign lenders, thus stabilizing domestic financial markets; they were not meant to address the underlying structural weaknesses of the economy. From the beginning, therefore, operational restructuring and institutional reform have been carried out simultaneously, without making distinctions between the short-term priority of liquidity management and the medium-term priority of foundation building for the prevention of future crises. This strategy has interfered with the implementation of institutional reforms in two ways.

First, as discussed in Section 3, the rush to introduce new corporate governance, a new regulatory and supervisory structure, new accounting standards, and even to initiate legal and judicial reform in disregard of the difficulty of assimilating a set of alien institutions, has resulted, in many cases, in cosmetic reform. Second, once the recovery got under way, it has become difficult to maintain the momentum of reform, because the recovery has diminished the need to improve foreign investors' confidence in the crisis countries. Foreign investors and lenders, moreover, have been losing interest in monitoring the progress these countries are making toward planned reforms and have exerted little market pressure to keep them on course. In adjusting the sovereign ratings of the crisis countries, for example, the rating agencies



seem to attach more weight to improvement in the external liquidity position and in macroeconomic variables than in progress toward restructuring. This lack of foreign pressure has allowed the crisis-country authorities to assume that the international community is satisfied with the level of progress achieved.

*The Fallacy of Banking Reform before Corporate Restructuring*

The IMF and country policymakers knew, from the experiences of other crisis countries, what should be done with regard to financial restructuring. However, there was no known best practice for corporate restructuring when nearly all of the corporations in the manufacturing sector were perceived to suffer from liquidity problems, as in Korea, and when all of the real-estate, construction, and infrastructure sectors were lying in ruins, as in most of East Asia. Debtors and creditors did not understand why such an alien approach as the London Rules of voluntary out-of-court settlements had to be chosen for the workout of corporate debt, and why reducing the debt-equity ratio so drastically in the short run was critical to the success of the IMF programs. Opinions were also divided, and remain so to this day, about the advantages and disadvantages of government-owned, centralized, asset-management companies, as opposed to privately owned, decentralized asset-management companies for the management and disposal of NPLs at banks.<sup>14</sup>

The adoption of the London Rules for corporate restructuring was to some degree dictated by the absence of the market and government institutions—such as merger and acquisition and a well-functioning court-based resolution procedure—that were necessary for a market-led restructuring. In out-of-court workouts, the government was supposed to play the role of mediator, facilitating an orderly debt resolution, and banks were supposed to act as creditors, managing the workout of corporate debt; in most cases, however, the government dictated the process.

<sup>14</sup> Korea, Malaysia, and, more recently, Indonesia have established centralized asset-management companies, whereas Thailand has chosen a decentralized process by which each commercial bank is encouraged to establish its own asset-management company. Asset-management companies can be effective in resolving insolvent financial institutions and selling their assets, although they are not expedient vehicles for corporate-debt workouts, in particular in manufacturing (Klingebiel, 1999). A centralized asset-management company is often more effective than a private company in forcing the operational restructuring of insolvent financial institutions and has the advantage of centralizing scarce skilled personnel. It can, however, become a place where NPLs and collateral are parked for a long period, instead of being liquidated (Lindgren et al., 1999).

In retrospect, it seems that corporate restructuring should have been treated as an integral part of financial restructuring. The strategy that was followed, however, called for banks to be, first, restructured, by cleaning up their balance sheets and building up their equity base, and, then, to be allowed, by varying degrees, to take charge of restructuring ailing corporations. The rationale for this strategy was that once the banks were rehabilitated, their structure of governance and prudential framework would provide powerful levers to bring about corporate restructuring (Lindgren et al., 1999). This strategy has been ineffective, however, largely because many of the state-owned banks, which now dominate the banking industry, have been subject to moral hazard with respect to public enterprises and because they have been unable to resume normal lending operations. These problems have delayed the recovery as well as the restructuring process. The bank-first strategy therefore posed a serious threat of necessitating repeated bank recapitalizations. The recent experiences of Thailand and Korea are cases in point.

When a bank was recapitalized through the injection of public funds, its management was invariably installed by the government. As is often the case with public enterprises, the state-appointed bank managers have been unwilling to change the status quo. They have also had little incentive to collect overdue loans or to engage in workouts of weak but potentially viable corporate borrowers.

Because it is difficult to identify potentially nonviable firms and to forecast accurately how many of the restructured firms can survive the current problems, corporate restructuring will not necessarily restore soundness to the recapitalized banks' balance sheets; its success very much depends on the speed of economic recovery. Under these circumstances, the restructured banks have taken an easy way out: they have avoided corporate workouts as much as possible, so as not to increase their holdings of NPLs or to lower their profits. Because the banks have thus kept on their loan portfolios many weak or near-bankrupt corporations, they have had insufficient lendable resources for the credit needs of healthy borrowers. This moral-hazard problem has therefore delayed corporate restructuring and resulted in a deterioration of bank-asset quality, which has, in turn, undermined the long-term viability of the banks.

As noted above, the banks in the crisis countries were obligated by the IMF programs to comply with new, more rigorous, regulatory requirements, including a CAR of over 8 percent. Because most of the banks were (and still are) unable to raise equity capital, they had either

to reduce their holdings of risky assets (mostly loans) or to issue high-cost subordinated bonds to replenish their capital. Whichever option was chosen, the higher CAR has been costly and has undermined their earning prospects. Lower profits have, in turn, lowered the franchise values of these banks, further limiting their access to the capital market. Although it has been suggested that the lower franchise value could lower incentives for making good loans, thereby increasing the problem of moral hazard (Hellmann, Murdock, and Stiglitz, 2000), there is no evidence that the East Asian banks have resorted to gambling in the face of the declining franchise values. On the contrary, they have become more averse to lending risk. Once public funds or taxpayer moneys were injected into insolvent banks, the authorities of the crisis countries set a higher standard of performance for these institutions than for others in terms of net profits and the volume of NPLs. Knowing that the government is unlikely to tolerate further losses or deterioration in the quality of assets, bank managers have withdrawn from more lending, particularly to small and medium-sized firms. This contraction in lending capacity, in particular in Malaysia and Thailand, has been severe and has slowed both recovery and corporate restructuring.<sup>15</sup>

The problems related to the regulatory upgrade were further complicated by the accounting firms and investment banks hired to conduct due diligence of banks and other nonbank financial institutions. In order to assure credibility with respect to reforms and in lieu of reliable domestic agencies, the crisis countries sought, at the beginning of the crisis, the services of U.S. and European accounting firms, consulting agencies, and investment banks to estimate the NPLs at, and advise in the restructuring of, financial institutions. These foreign organizations followed Anglo-American standards of due diligence and restructuring that were unfamiliar to the crisis-country managers and were more stringent than those to which they had been accustomed. Furthermore, given the pessimistic outlook of the economy, they were inclined to overstate the numbers of NPLs at the banks. Because they were also concerned about their potential liability in case they overvalued assets (Lindgren et al., 1999), they often magnified the bad-loan problems at banks beyond a manageable level, thereby deepening the credit crunch.

<sup>15</sup> At the same time, the stock exchange of Thailand stipulated prerequisites for new entrants: stringent minimum profits for several consecutive years and a minimum number of shareholders, among other requirements. Most SMEs were barely able to meet these prerequisites, and their access to commercial banks and finance companies was consequently drastically reduced (Pakorn, 1999).

Once they were subject to these new and tougher criteria for loan evaluation and due diligence, the main creditor banks and debtors found it difficult to reach agreement on the modality of debt workout. The insolvent corporations objected to what they perceived to be a fire sale of their assets; the commercial banks lacked staff experienced in managing corporate-debt workouts. Instead of evaluating project viability and debt-service capability of workout candidates, banks in Thailand, for example, were more inclined to foreclose and recover as much of their loans as they could if the candidate clients had pledged enough reliable collateral or guarantees. If they had not, the banks would keep them on their books and continue to provide short-term emergency financing so as not to incur further losses (Pakorn, 1999).

## **6 An Agenda for Sustaining Recovery**

### *Setting Priorities*

The preceding assessment suggests that the current strategy of restructuring and reform is, unless adjusted, likely to inhibit and hence delay the ongoing recovery in the East Asian economies. This is no longer justifiable. This section will argue that, in order to manage the current crisis better and to prevent future crises, the crisis countries must adopt a strategy different from the one designed by the IMF in terms of short- and medium-term policy objectives. This strategy should focus on three policy priorities:

- Accelerating growth by both promoting investment and shifting the emphasis from operational restructuring of the financial and corporate sectors to economic growth accompanied by institutional reforms and institution building;
- Increasing reliance on the existing and newly developed frameworks for a market-led reform strategy for operational restructuring (rehabilitation and recapitalization of financial institutions and corporate-debt workouts) with minimum direct governmental intervention, except in Indonesia;
- Developing a detailed long-term plan to formulate and implement a program of institutional reforms with respect to the legal, judiciary, and civil-service systems, as well as to standards, corporate governance, bankruptcy procedures, and industrial organization, with due consideration given to the capacity of the crisis countries to change and adapt.

It is generally agreed that the most urgent task facing the East Asian authorities is to steer their economies back to a path of durable and

stable growth. The financial crisis has inflicted enormous damage on the region for the past two years, particularly on the most vulnerable segments of the society. The erosion of social and organizational capital caused by the increasing number of bankruptcies may no longer be tolerable (Stiglitz, 1999). What, then, should policy priorities be in the short run? Although a single strategy cannot be applied to all the crisis countries, two components are important. One is to place more emphasis on expanding public expenditures, preferably on education, skills, and research to develop a strong institutional infrastructure and to promote the development of the knowledge economy and information-technology (IT) industries that most of the East Asian governments think will improve efficiency (World Bank, 2000a and 2000b, chap. 3). The other is to sustain an expansionary, or at least an accommodating stance of, monetary and fiscal policy together with an institutionally supported policy designed to revive capital investment.

At this stage in the recovery, this strategy—in particular, the stimulation of investment—is strongly opposed by the IMF and World Bank. One of their concerns is that such a strategy could be interpreted as unwillingness on the part of the crisis countries to resolve structural problems and could therefore undermine the confidence of foreign investors should a modest recovery dilute the sense of urgency to restructure the economy. They also argue that the strategy is likely to be inefficient and distortionary, because investment has become less productive since the early 1990s, and there are still numerous vacant office buildings in East Asian cities and substantial unused capacity in manufacturing (World Bank, 2000b). The concern about distortions is further reinforced by the empirical studies of TFP, which in general show that productivity growth has been slow in East Asia compared to growth during the early years of today's industrial economies. A third criticism is that the promotion of investment is not likely to be feasible in view of the serious banking-sector problems and fiscal constraints that still beset the crisis countries.

As for the concern that the crisis countries may be seen as unwilling to restructure, the adoption of international banking standards by these countries, the tightening of financial supervision and regulations, and the improvement in the balance sheets of their financial institutions may help reassure foreign investors and make the economies of these countries less vulnerable to future crises. As discussed in Section 5, however, these reform measures may also be counterproductive, to the extent that they exert deflationary effects and thereby delay recovery in the short run. Prolonging the recession may expose the crisis countries

to the greater risk of another round of speculative attacks, because foreign lenders and investors are more likely to be deterred by a deterioration in macroeconomic performance than by slow progress toward reform (as illustrated by the behavior of the rating agencies). The remainder of this section will show that the arguments of the IMF and World Bank with regard to efficiency and distribution are contrary to the realities of the East Asian crisis countries.

#### *Distortions and Inefficiency*

After the crisis in 1997, investment in the four crisis countries plummeted by as much as 50 percent in 1998 (Table 5). In Indonesia, Malaysia, and Thailand, the volume of investment continued to decline until the first quarter of 2000, with few signs of recovery. In Korea, investment demand recovered somewhat, but real gross investment during the first quarter of 2000 was only about 65 percent of the previous year's level. In the meantime, the sharp fall in investment has generated a large surplus on the current accounts of these countries, because the saving rates have changed very little. Should these countries let investment demand decline further in order to work off unused capacity in real estate and in manufacturing?

There are three reasons why expansionary macroeconomic policies aimed at promoting investment may not necessarily be inefficient or distortionary. One, there is, at present, considerable slack in the crisis economies. Two, there is no strong evidence that investment was becoming less efficient before the crisis. Three, new capital will be more productive than existing capital, because much of the future investment is likely to be concentrated in knowledge-based and IT industries. I discuss each of these in turn.

*Slack in the economy.* Unemployment in the crisis countries is still high compared to precrisis levels, and, except in Korea, capacity-utilization rates are low. Other indicators showing the weakness of aggregate demand are that:

- Except in Indonesia, prices have been, and are expected to remain, stable in East Asia. Partly for this reason, the real rates of interest are still above precrisis levels. In Malaysia and Thailand, the level of domestic credit has actually declined for the past two years.
- The current account generated surpluses of between 2.4 percent (Korea) and 9.9 percent (Malaysia) of GDP in 2000, following two years of massive surpluses. These large current-account surpluses have led to the appreciation of the Korean, Malaysian, and Thai currencies. Any further appreciation will discourage exports and may lower do-

mestic interest rates. However, because all of the crisis countries depend on exports as a leading source of growth, the deterioration of export competitiveness may not stimulate domestic investment, even if domestic interest rates fall.

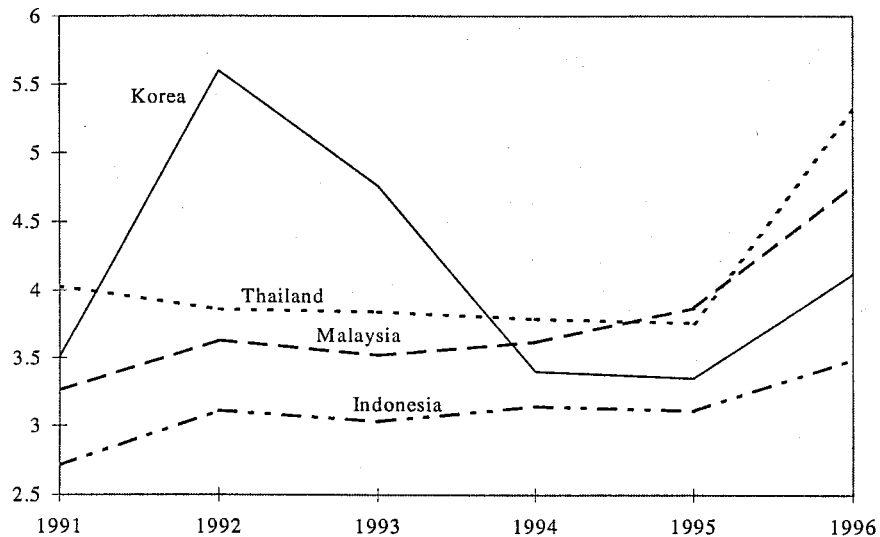
- Consumption expenditure as a percentage of GDP is approaching precrisis levels, leaving little room for consumption-led growth. Many recent forecasts suggest that export growth will slow down. Because fiscal deficits as a percent of GDP have been modest in the crisis countries, additional government spending is not likely to raise interest rates or crowd out private investment, so long as the spending is kept at reasonable levels. Given the rigidities of fiscal policy in general and the risk of aggravating government-debt problems in particular, the four countries cannot rely entirely on fiscal stimuli for recovery. This means that the ongoing recovery could peter out unless investment demand rises.

*Excess capital and investment efficiency.* Many critics of the East Asian development model argue that much of the capital that began to surge in during the early 1990s was misallocated by banks that were controlled by the government and used as instruments of industrial policy to finance investment in property and in low-return, state-initiated, projects in the automobile, steel, chemical, and semiconductor industries (“Frozen Miracle,” *Economist*, March 7, 1998; Eichengreen, 1999; World Bank, 2000b chap. 2). As a result, precrisis growth in East Asia was not proportional to the increase in investment (World Bank, 2000b, p. 22). At the macroeconomic level, efficiency declined, as shown by a sustained increase in incremental capital-output ratios (five-year moving averages) during the 1990–96 period (World Bank, 2000b, p. 70).

Susan Collins and Barry Bosworth (1996) calculate the incremental capital-output ratios for the four East Asian countries. They find that the ratios had remained relatively stable before jumping up in 1996 and that they neither display cyclical fluctuations nor suggest that investment became less productive before the crisis (Figure 2).<sup>16</sup>

<sup>16</sup> The ratio is sensitive to fluctuations in output in the short run. For example, external shocks such as the appreciation of the U.S. dollar or a deterioration in the terms of trade could adversely cause many of the export-oriented East Asian economies to suffer a fall in output. The fall will then push up the incremental capital-output ratio, independently of changes in the rate of return to capital. This appears to be what occurred in East Asia during the two years preceding the crisis. When these ratios are calculated in terms of national-income data, they are seen to have risen sharply since then, largely because investment has contracted.

FIGURE 2  
 INCREMENTAL CAPITAL-OUTPUT RATIOS, 1991-1996  
 (Percent)



SOURCE: Collins and Bosworth (1996).

At the microeconomic level, the World Bank (2000b) argues that the profit rates of East Asian corporations were low and falling. A recent study by Stijn Claessens, Simion Djankov, and Larry Lang (2000), however, estimates several measures of corporate performance and finds that profit rates of East Asian manufacturing corporations were, except in Korea, not low and that their decline was marginal (Table 6). In fact, the authors argue, operational margins of Korean and Malaysian firms rose in 1995 and 1996. Real returns on assets in Indonesia and Thailand, moreover, were twice as high, on average, as the returns in Germany and the United States during the same period. In view of this evidence, the authors conclude that "the East Asian miracle was indeed based on a vibrant corporate sector" (Claessens, Djankov, and Lang, 2000, p. 2).

There is little doubt that offshore financing fueled much of the real-asset boom in East Asia, and that the observed slowdown in the overall productivity and profits of the economy may reflect, as Morris Goldstein (1998) notes, a massive increase in investment in property. Investment efficiency in other sectors of the East Asian economies, in particular in manufacturing, may not have declined before the crisis as much as has been claimed.



TABLE 6  
MEASURES OF CORPORATE PROFITABILITY IN EAST ASIA, 1988 TO 1996

	1988	1989	1990	1991	1992	1993	1994	1995	1996
			INDONESIA						
RROA in local currency	—	—	9.4	9.1	8.6	7.9	7.4	6.2	6.5
ROA in normal U.S. dollars <sup>b</sup>	—	—	16.0	13.7	12.0	15.3	11.7	10.7	11.2
Operational margins <sup>c</sup>	—	—	—	35.7	33.3	34.4	32.8	31.2	30.6
			KOREA						
RROA in local currency	4.4	3.9	4.1	4.0	3.9	3.6	3.4	3.6	3.1
ROA in normal U.S. dollars <sup>b</sup>	25.1	10.3	7.3	7.2	6.4	5.9	12.1	9.9	-1.0
Operational margins <sup>c</sup>	13.7	16.8	17.3	16.9	19.2	18.7	19.6	21.4	22.1
			MALAYSIA						
RROA in local currency	5.4	5.6	5.4	6.2	6.9	6.5	6.3	6.1	5.6
ROA in normal U.S. dollars <sup>b</sup>	-0.8	8.8	7.2	9.9	14.8	6.1	15.5	12.2	9.5
Operational margins <sup>c</sup>	16.4	16.3	17.1	17.3	17.6	17.4	18.4	19.5	25.5
			THAILAND						
RROA in local currency	10.8	11.0	11.7	11.2	10.2	9.8	9.3	7.8	7.4
ROA in normal U.S. dollars <sup>b</sup>	13.9	14.6	19.3	16.9	13.4	13.1	16.6	13.2	—
Operational margins <sup>c</sup>	21.9	24.3	25.7	27.3	25.9	25.1	24.9	24.7	22.7

SOURCE: Claessens, Djankov, and Lang (2000).

NOTES: Measures are based on balance-sheet and income-statement data from 317 companies in Indonesia, 392 in Korea, 772 in Malaysia, and 564 in Thailand. Real returns on assets (RROA) are calculated as earnings before interest and taxes, divided by total assets, minus inflation. Returns on assets (ROA) are calculated in U.S. dollars. Operational margins are the difference between the sales and costs of goods sold as a share of sales.

Other evidence also suggests that returns on capital were not as low as claimed by the World Bank report (2000b). By the end of 1999, the rate of capacity utilization in Korean manufacturing rose to 85 percent; capital spending has consequently been on the rise and is expected to grow further in 2000. The massive increase in unused capacity in 1998 may therefore have been the result of a cyclical downswing and of the crisis itself, but not vice versa. In the other crisis countries, excess capacities exist, mostly at large firms. An increase in aggregate demand is likely to increase utilization rates in these countries, as it has in Korea.

Even if there had been excess capital in many East Asian industries before the crisis, this would not necessarily imply that a policy promoting investment was misguided, because the stock of capital in the crisis countries has decreased considerably in the three-year period since the crisis. Numerous vacant office buildings in the region are decaying, and a great many manufacturing firms have been liquidated or placed under court receivership or bank workouts. As a result, the crisis countries are littered with deserted factories and closed plants, which are often sold for their value as scrap. Although there are no reliable statistics, the large volume of NPLs as a proportion of GDP in all the crisis countries suggests a substantial erosion of capital stocks since 1997.

*The productivity of new capital and total-factor productivity.* Although the considerable slack in the economy justifies an expansionary policy for investment, such a policy will not be viable unless it can be shown that it will be accompanied by an increase in investment efficiency—that is, that the rate of return to new capital will be growing and will be higher than that of the existing stock. Two developments are expected to improve investment productivity:

- Over the last two years, the East Asian crisis countries have, as one of their reform priorities, strengthened regulations on bank-asset management and lending, particularly for real estate. Property markets, moreover, are still in a deep slump, with vacancy rates in commercial buildings ranging from 15 percent in Kuala Lumpur to 37 percent in Bangkok and rental rates remaining at half the 1997 levels in all major East Asian cities. In addition, a large number of property investors have been placed under debt workout. Under these circumstances, expansionary policy is not likely to result in an unsustainable rate of investment in real property or to ignite another real-estate boom.
- The new emphasis on improving TFP will be an important source of medium-term growth in East Asia. A number of recent empirical studies on TFP show that productivity gains have been slow in East

Asian economies, although they are a lot higher than similar figures for other developing countries (Yusuf, 2000). These studies suggest that the East Asian crisis countries can return to past growth rates by improving productivity, even if saving and investment rates fall below precrisis levels.<sup>17</sup> This prospect has encouraged many East Asian countries to embark on a new strategy of developing knowledge-based and IT-oriented industries, and they are being supported by the IMF and World Bank. This shift in investment is expected to improve national productivity and the competitiveness of many other traditional industries and firms.

Except for Japan, Korea, and Taiwan, the East Asian countries are either technologically disconnected or remain in a group of technology adopters. Without adequate investment in IT industries, which will at least facilitate the introduction of new technology embodied in imported capital goods, productivity growth in the crisis countries could lag further behind that of the advanced economies (Sachs, 2000).

A recent World Bank (2000b, chap. 7) study shows that without higher productivity growth, output growth per person will decline from an average of 5.1 percent during the 1980s and 1990s to 4.2 percent during the next decade. This is because, assuming the same annual rate of investment in the next decade as in the 1990s, the increase in the capital-labor ratio will slow down. It should be cautioned, however, that potential productivity gains will not materialize in the short term, because building the market-supporting infrastructure required for improvement could take some time. This means that investment as a proportion of GDP, which fell to 13 percent in Indonesia and to 26.8

<sup>17</sup> It should be noted that although returning to the precrisis trend growth may hinge on TFP gains in the crisis countries, TFP estimates do not necessarily indicate whether investment rates are excessive or not. That is, the findings of low TFP growth in East Asian economies by Young (1995) and others do not necessarily prove that capital investment was excessive in these countries. Furthermore, there are clearly limits to the conventional growth-accounting method, because it does not clearly distinguish between different sources of growth. If capital and technology cannot be clearly separated, then TFP is not a true measure of technology progress. The distinction between capital and technology is often ambiguous. If technology is embodied in imported capital goods, it is difficult to separate capital from technology. Growth accounting is a mere mechanical calculation; it does not explain a causal relationship. For example, if technology grows at an exogenously given rate of  $x$  at the steady state, capital and output will also grow at the same steady-state rate ( $x$ ). Growth accounting will then attribute only the capital share ( $\alpha$ ) of output growth to capital growth. Thus, although the true contribution of technology to output growth is 100 percent, growth-accounting underestimates it by  $(1 - \alpha)$  (Easterly and Levine, 2000).

percent in Korea in 1999 will have to be raised to the precrisis average of more than 35 percent to sustain a 4 to 5 percent growth of GDP in the crisis countries during the coming decade.

One may conclude that the crisis countries have substantial room for expansionary policies, but that unless demand for investment rebounds soon, they may not be able to sustain the ongoing recovery (although, from a longer-term perspective, investment may be expected to increase, especially if IT industries lead the recovery). Because economic growth in all of the crisis countries depends heavily on exports to Europe and North America, these countries will have to invest in developing new products and businesses and in acquiring new technologies in order to remain competitive in the rapidly changing global market. If investment demand continues to stagnate, so will import demand. And because these countries depend a great deal on imported capital goods to obtain embodied foreign technology, they risk losing out in global competition if investment does not recover soon.

## **7 Growing Out Rather than Restructuring Out**

Carl-Johan Lindgren et al. (1999) suggest that, at the present stage of recovery, direct and indirect measures to stimulate credit are not likely to increase banks' lending capacity and that only regained profitability and solvency in the banking and corporate sectors will change bank behavior. Numerous World Bank and IMF publications about the East Asian crisis unequivocally recommend that banks and other unsound financial institutions must be cleaned up and that insolvent firms must be either liquidated or made subject to debt workouts as soon as possible as preconditions for recovery and sustainable growth.

### *The Limit of Restructuring Out*

Although the restructuring-out strategy may sound reasonable, it defies the realities of and constraints on financial and corporate restructuring. A more aggressive government intervention through the removal of NPLs and the injection of public funds for recapitalization will be counterproductive because of the difficulty of assessing operational restructuring targets, the high fiscal cost of restructuring, the enormity of the corporate-debt problem, and the future burden of divesting state-owned financial institutions and assets.

*The credibility of restructuring targets.* As noted above, in assessing the quality of assets held by banks, the regulatory authorities in the East Asian countries have adopted a set of forward-looking criteria that

include the cash-flow and earning prospects of bank borrowers. Because it is difficult to forecast profits of individual firms in different industries, these criteria can, at best, serve as broad guidelines for estimating the volume of NPLs at banks. For example, when the macroeconomic outlook deteriorates, the number of borrowers who are unable to meet loan payments increases and the volume of NPLs at the banks also increases. Depending on the prospects for growth in the economy, the stability of the financial markets, and the balance of payments, there can be as many different estimates of the expected increase in NPLs as there are forecasts.

The corporate-debt workouts at banks pose a similar problem. Many of the corporations whose debts have been restructured may be subject to another workout if they are unable to improve their cash flow and profitability. Once again, it is difficult to estimate the number of restructured firms that are at risk. So long as banks are hampered in their lending, interest rates are kept at high levels, aggregate demand remains depressed, and the number of restructured firms that fail to survive will rise. Their failures will then be translated into an increase in NPLs at banks, again impairing bank soundness.

The forward-looking criteria can also be a source of moral hazard in that both the regulatory authorities and financial institutions have incentives to be conservative in their estimation of NPLs. Banks and other nonbank financial institutions, abetted by auditors, may attempt to hide their losses by underestimating their holdings of NPLs.<sup>18</sup> The regulatory agencies, for their part, often accept the conservative estimates both to avoid a consequent deterioration in the quality of bank assets and to reduce, in a crisis situation, public-fund requirements for restructuring. Even an objective due diligence does not reveal the true extent of NPL problems at troubled financial institutions, because estimates of NPLs can vary significantly, depending on the application of the forward-looking criteria. When the moral-hazard problem is pervasive, market participants distrust official NPL estimates, and policymakers therefore do not know *ex ante* what level of restructuring is needed to restore soundness to financial institutions in difficulty. Given this uncertainty, policymakers usually settle on lower, rather than higher, figures for NPLs. The first phase of financial and corporate-sector restructuring therefore falls short of market expectation *ex*

<sup>18</sup> As noted above, the crisis countries sought to avoid this problem and to ensure the credibility of due diligence by hiring foreign accounting firms during the first stage of operational restructuring. As also noted, however, the accounting firms went to the other extreme.

*post*, requiring a second round of resolution and recapitalization. This problem of credibility may not be avoidable unless the regulatory system is improved and, more importantly, unless the market itself assumes a greater role in restructuring.

As long as macroeconomic prospects remain as uncertain as they are in Indonesia, Malaysia, and Thailand, it will be difficult to determine the target level of operational restructuring that will be acceptable to financial-market participants. Indeed, the experience with restructuring in East Asia during the last two years suggests that cleaning up banks and reducing the level of corporate debt can be a slow process. Capital investment is likely to suffer during restructuring, because most weak corporations are not in a position to contemplate new investment while undergoing debt workout, and viable corporations may not have access to bank lending. As discussed in Section 6, stagnant investment demand will slow the recovery; the resulting sluggish economy will exacerbate problems related to NPLs and corporate-debt; and these problems will, in turn, act as a constraint on recovery, creating a cycle in which restructuring and recession reinforce each other to deepen the crisis. If the crisis countries are going to be as mired in the restructuring of financial institutions and corporate debt as they are now, the ongoing recovery may be short lived.

*The high fiscal burden of operational restructuring.* All four crisis countries have been, and will continue to be, hard-pressed to mobilize the sizable amount of public funds needed for operational restructuring. The estimates made by Claessens, Djankov, and Klingebiel (1999) show that fiscal costs incurred by the restructuring programs as a percentage of 1998 GDP range from 11 percent in Malaysia to 37.3 percent in Indonesia (Table 1). Although they do not specify target levels of financial and corporate restructuring, expected additional costs would amount to 15.4 percent of GDP in Thailand and 12.7 percent in Indonesia to complete the restructuring process. If the ongoing recovery is derailed, the expected costs will no doubt multiply. Do these countries have the ability to mobilize such a large volume of additional public resources, when public debt as a proportion of GDP already stands at 37 percent in Korea and at almost 100 percent in Indonesia? It is clear that they do not. Given this high debt burden and a limited tax base, the crisis countries, especially Indonesia and Thailand, will find it extremely difficult to raise the additional amounts needed for restructuring, and almost impossible if the ongoing recovery is interrupted.

For the sake of argument, however, suppose these countries are able to raise the required amount. How will these public resources be

allocated under the current restructuring arrangements? A substantial portion of the public funds used for the rehabilitation and recapitalization of banks and other financial institutions will be dissipated in increasing banks' CARs and loan-loss provisioning. Recapitalized banks are also likely to add liquid and safe short-term assets to their asset portfolios as long as they cannot find creditworthy borrowers. When banks hold large amounts of capital, invest in short-term securities rather than increase lending, and extend new loans to nonviable firms kept on their books, the fiscal support given may not necessarily succeed in augmenting the financial resources available for corporate investment. A strong case might therefore be made for allocating available fiscal resources to the financing of public expenditure (including outlays for social infrastructure) and for providing incentives for private investment.

*The corporate-debt burden.* The enormity of the corporate-balance-sheet problem also weakens the case for an aggressive operational restructuring. According to Claessens, Djankov, and Klingebiel (1999), at current interest-rate levels, about 17 percent of corporations in Korea, 25 percent in Thailand, and more than 50 percent in Indonesia may be unable to cover interest expenses from operational cash flows by the end of 2002. This is one of the reasons why they believe many corporations are unable to grow out of their debt problems and why more aggressive corporate restructuring must precede, or at least be carried out in conjunction with, expansionary policy. Does this mean that many of these insolvent corporations will then have to be liquidated or be forced to seek court protection?

With a crisis as severe as the East Asian crisis was and recovery prospects as pessimistic as they initially appeared to be, few firms appeared sound and profitable when viewed through a set of forward-looking criteria. Certainly, there were more bankrupt corporations than viable ones. Three years later, there are still a great many firms that are unable to service their debts, and that number is likely to remain high if the recovery in the crisis countries is not maintained. Once a firm is identified as a candidate for debt restructuring, it loses access to the financial markets and becomes insolvent, regardless of its long-term viability. The debt-workout criteria for troubled firms, moreover, are often subjective and arbitrary, creating opportunities for political influence and corruption. Subjecting all of these troubled firms to debt restructuring by banks that are barely surviving themselves and are incapable of distinguishing between viable and nonviable firms is risky and could dislocate many industries beyond repair.

Although reliable statistics are not available, the share of distressed firms appears to be declining much faster than expected in Korea, where GDP is expected to grow 9 percent in 2000. It would not be surprising if similar developments are observed in other crisis countries where growth has recently accelerated. In view of this development and of the difficulty of separating out potentially profitable firms from a group of debt-workout candidates, a preferable strategy during a crisis would be to stagger corporate restructuring over time, while stimulating domestic demand to revive the economy.

*The reprivatization problem.* If the governments in the crisis countries choose to intervene in the restructuring more extensively than before, they will most likely end up taking over more of the remaining private financial institutions and of directly managing more corporate-debt workouts. This has, in fact, been occurring. Such an interventionist approach may, in the end, prolong, rather than hasten, the restructuring process. The future reprivatization of state-owned financial institutions, which will be necessary for the transition to a market-oriented reform, can be expected to meet with strong resistance from employees of the now state-owned financial institutions and to be bogged down in bureaucratic delays and corruption.

There are other reasons for the slow progress toward reprivatization in the crisis countries. Policymakers may not yet have found time, while struggling with restructuring, to engage in reprivatization. They may not have been able, moreover, to forsake their old habit of dictating the asset management of financial institutions for the conduct of industrial policy. Most important, however, they may not have been able to find qualified domestic buyers for these institutions or to deflect public apprehension about selling them to foreign investors. If, as in all the crisis countries except Korea, the separation of banking from commerce is achieved by limiting individual ownership of bank stocks, large family-owned business groups—the only groups that have the money to acquire banks—will be barred from owning and managing these institutions (as Korea's *chaebol* are). This limitation leaves very few eligible buyers.

Selling the banks to foreign entities has been, and will continue to be, opposed on the ground that foreign-owned banks may be insensitive to the banking needs of local businesses, which differ from those in Western economies. Foreign banks tend to rely more on modern techniques of risk management than on cultivating long-term relations with borrowing customers. They may also have less access than local



banks have to market information, much of which is informal, especially in close-knit East Asian societies. For these reasons, foreign banks have limited their exposure to small and medium-sized firms, preferring, instead, to lend to multinational and blue-chip corporations and consumers and to specialize in trade and international corporate financing.

It is also widely perceived that foreign investors are bargain hunters and that they are not willing to pay the “right” prices for the banks put on the market. Given this perception, which has been aggravated by acrimonious negotiations over sales in some of the crisis countries, it is expected that few East Asian banks will be taken over by foreign investors and management in the near future. As long as prospective buyers, either domestic or foreign, are not found, however, many of the state-owned banks will remain inefficient public enterprises.

### *Growing Out*

If restructuring out is not a viable strategy, is there a more realistic and effective alternative for crisis resolution at this stage of recovery? The preceding discussion makes a strong case for substantially reducing the scope of government involvement and for as soon as possible leaving the bulk of the operational restructuring task to the market, relying on the existing and newly developed framework of crisis resolution. There are also grounds for a more expansionary macroeconomic policy, because investment demand has become stagnant. Such a policy would be more effective, however, if the scope of bank restructuring were adjusted by lowering the required levels of capital adequacy, staggering loan-loss provisioning requirements over a number of years, and relaxing the restrictions on debt-equity swaps, so that banks could engage more actively in corporate-debt workouts and return to normal lending.

Growing social tension regarding the equitable sharing of restructuring costs is another justification for the growing-out strategy. Bank restructuring and corporate-debt workouts have invariably entailed cutting the work force. At the beginning of the crisis, these layoffs were regarded as unavoidable and accepted with great reluctance. Once recovery got under way, however, the manpower adjustment has become much more difficult in the face of the growing militancy of labor unions and conflicts about who should bear the burden of the restructuring. In the absence of institutions for conflict management, the crisis countries may be unable to maintain social cohesiveness and political stability if they single-mindedly follow the operational restructuring.

Most of the crisis countries have turned to fiscal stimuli to revive domestic investment over the past year and a half. Thailand, for example,

introduced a fiscal-stimulus package in March 1999 that contained a cut in the value-added tax rate and an income-tax waiver. This was followed by a fiscal-expansion package that reduced import tariffs for a number of commodities used as inputs in manufacturing and allowed the use of accelerated depreciating schedules. The Thai authorities have also established three new investment funds in cooperation with the Asian Development Bank (ADB) and the International Financial Corporation (IFC) for investments in large restructured firms and in small and medium-sized firms (World Bank, 1999).

Although the major components of any fiscal-stimulus package, including tax benefits and required public expenditure, are likely to be similar in all crisis countries, the implementation of particular measures selected from a large menu of alternative instruments will differ a great deal from country to country. The policymakers of the crisis countries know which fiscal-policy instruments are at their disposal and how effective they are. What is needed at this stage is not a debate on the relative effectiveness of alternative fiscal tools, but recognition by the authorities of the nature of the recession and institutional constraints and a commitment to support domestic investment through a set of expansionary monetary and fiscal policies.

## **8 Market-Based Operational Restructuring and Institutional Reforms**

The emphasis on growth cannot be at the expense of financial and corporate restructuring and institutional reforms. While phasing out active state intervention, through public funding, in the restructuring, the crisis countries should focus on a market-led approach to improve the soundness of the banking sector and remove corporate-debt overhang. As discussed in Section 2, all of the crisis countries have tried to establish an elaborate institutional framework for market-led financial and corporate restructuring. So far, the legacy of the East Asian development paradigm, the lack of skilled and experienced staff, and bureaucratic inertia have limited the role, as well as the effectiveness, of these institutions. Because the market-led approach will entail substantial adjustment costs as well, policymakers in the crisis countries have lacked the confidence and courage to make the shift. Unless policymakers are prepared to test the effectiveness of the market-led approach, however, to “learn by doing,” they will never know what defects the strategy has and how it can be improved to restructure their ailing banks and corporations. In the interim, an increase in growth, with the recovery of

asset prices, will create greater incentives for both creditors and debtors to participate in the restructuring process.<sup>19</sup>

### *Market-Based Restructuring*

Three measures might constitute a market-led restructuring strategy: the reprivatization of financial institutions and corporate assets, the easing of restrictions on foreign entry into the domestic financial-services industry, and recapitalization through the stock market.

- There is little disagreement that market-based reform should begin with the reprivatization of state-owned banks, nonbank financial institutions, and corporate assets. If ownership and management control of the major banks and other financial institutions remain in the hands of the government, as is likely, the government will be unable to extricate itself from its extensive involvement in the reform process, leaving little room for the market to intervene. After three years of operational restructuring, however, the crisis countries have reached a point where they can no longer postpone returning the financial institutions acquired by the state to the private sector. Reprivatization holds the key to the successful reform of both corporate governance, in general, and the large family-owned groups that dominate many industries, in particular. Reprivatization will also help ease the growing government debt burden of restructuring and secure the additional public funds needed to implement a second round of restructuring should it be needed.

If a separation between banks and commerce is desirable, then a single individual or family-owned conglomerate should not be allowed to own a large stake in any financial institution. The state-owned bank stocks will therefore have to be widely dispersed to the general public. However, ownership dispersion does not necessarily prevent large groups from exercising management control, because they can always command a large block of voting stock by gathering together a number of small shareholders through a cross-ownership arrangement. Recognizing both this possibility and the difficulty of regulating such collusive behavior, the respective governments may try, as Korea has in the past, to thwart the conglomerates by forming their own groups of small shareholders (usually from other government-owned or controlled

<sup>19</sup> The market-led approach does not necessarily apply to Indonesia, however, where the state controls more than 75 percent of the liabilities of the banking sector and owns corporate assets valued at Rp 430 trillion (or 40 percent of GDP) through the IBRA. The Indonesian authorities must therefore accelerate the plans for restructuring, merger, and reprivatization of the state-owned banks and encourage the IBRA to accelerate the sale of NPLs transferred from unhealthy banks.

institutions). The government's counter-action may be justifiable, but it does not serve the purpose of reprivatization.

If widely dispersed ownership of financial institutions is not a viable option, then an effort can be made to establish privately owned investment funds created primarily for the takeover of these financial institutions. Another option might be to create financial groups, which are not subject to ownership restrictions and are not related to industrial groups or do not own any industrial or commercial entities except for their stocks for financial investment. To encourage the formation of such groups, the government could provide tax and other incentives to the large conglomerates to spin off their financial firms as independent financial groups or financial holding companies.

- The economic forces driving the globalization of finance have been gathering speed in recent years and will continue to do so. Regardless of their policy and strategic preferences, the East Asian countries will be forced to adjust to this trend by opening their intermediation markets and providing a level playing field for foreign competitors. The authorities in these countries should regard this market opening as an opportunity to exert pressure on domestic financial institutions to prepare themselves for foreign competition by improving their balance sheets and operations and by consolidating among themselves through mergers and acquisitions. Foreign competition will be a credible threat to the domestic financial institutions unless these institutions reform themselves voluntarily, before they lose their market share and are driven out of the domestic intermediation market.
- The market-led approach for reform will be more credible and viable if corporations and financial institutions are able to develop greater access to capital markets for investment financing and recapitalization. Many firms and financial institutions in Korea and Thailand were successful in raising equity capital and issuing debentures in 1999 when the stock markets in the region were booming. A recent financial-statement analysis by the Bank of Korea (2000), for example, shows that, at the end of 1999, the average debt-equity ratio of 2,046 sample firms in Korean manufacturing had fallen from 303 percent in 1998 to 214.7 percent in 1999. Over thirty-six points of the drop were accounted for by recapitalization through rights issue. A similar figure for a sample of 513 companies listed at the Korean Stock Exchange dropped from 277.7 percent in 1998 to 150.6 percent in 1999. During the same period, net profits of the listed firms as a percent of their total sales rose from -7 percent in 1998 to 4.4 percent in 1999, in

response largely to a decline in market interest rates and to the economic recovery.

Encouraged by the booming stock market, a large number of Korean financial institutions, including banks, were making plans to offer both common and preferred stocks in the domestic equity market and to issue global depository receipts to foreign investors. Korea's rapid recovery, combined with an upward adjustment in Korea's sovereign-credit rating, greatly eased the marketing of these instruments. In Thailand, the private sector has also been successful in raising capital through the issue of new equity and debenture. It raised B45 billion (US\$1.2 billion) from the stock market and issued B120 billion in debentures in 1999. In the first four months of 2000, Thai corporations raised B4.6 billion through the issuance of new shares and issued B52 billion in new debentures.

After a year-long surge, the stock markets of all four crisis countries have foundered again in 2000 and are expected to remain depressed, reducing the scope of bank recapitalizations and corporate-debt workouts through the equity market. Because a vibrant and growing capital market is likely to speed up the transition to a market-oriented reform, it is critical that the current recovery be sustained.

#### *Institutional Reforms: A New East Asian Paradigm*

The market-based approach will be more effective if it is supported by regulatory improvements and institutional reforms of the legal system and bureaucracy. An extensive theoretical and empirical literature suggests that institutions matter for growth (Mauro, 1994; Knack and Keefer, 1995; Rodrik, 1995, 2000; Temple and Johnson, 1998; World Bank, 2000b). As Rodrik (2000) puts it, the question is no longer whether institutions matter, but which institutions matter and how to develop them. A recent World Bank study (2000b, p. 144) shows that "a 20% improvement in macroeconomic, trade, financial, and public institutions can add 1.2–2.0 percentage points to a country's per capita growth."

In the early 1990s, many East Asian countries were following Washington Consensus reforms, which steered their economies toward deregulation and openness, with minimal influence from government. Democratic changes and globalization accelerated this trend. Because most of these American-style, liberal reforms ignored the role institutions could play in promoting economic and social development, however, they were ineffective. The Washington Consensus reforms were primarily focused on market liberalization and opening, fiscal

discipline, deregulation, and privatization. In recent years, these liberal reforms have elicited strong challenges from many quarters. Stiglitz (1998), for instance, argues that the Washington Consensus as an intellectual doctrine is too simplistic, because it ignores such important institutional factors as improvements in education and technology, the complementary governmental role, and effective competition and regulation policies.

Over the last two years, the rapid recovery has encouraged a reexamination of the East Asian miracle and a search for the kinds of institutional reforms the region must undertake to regain its precrisis dynamism and strength. The East Asian model of development may still be preferable to the American free-capitalism model for development of the region's economies. Many of the East Asian economies, however, including the crisis countries, will find it neither desirable nor feasible to return to the old East Asian paradigm. Not only does the trend toward democratization and market liberalization appear to be irreversible, but political liberalization has rendered ineffective and inoperable the East Asian governance system of cooperation and coordination, in which the government served as a senior partner (World Bank, 1993). Although there is no reason why a strong government, with the ability to commit itself credibly to long-term development goals and to choose appropriate policies (Bardhan, 1997), cannot survive democratic changes, the experiences of the crisis countries, all of which have pursued economic and political liberalization, suggest that democratic policies go hand in hand with a minimalist government. To be effective, a democratic regime with free markets will have to be supported by a set of new institutions, rules, and norms. Institution building is neither easy nor quick, and although the old system of governance is being dismantled, a new system is nowhere in sight, thrusting East Asia into what may be a long period of transition marked by uncertainty and confusion.

In charting a new development strategy after the crisis, many East Asian countries have accelerated their plans for building democratic and market institutions while improving the capabilities of their governments to manage the difficult period of transition. As for the main thrust of institutional reform, the East Asian countries may have to focus on five areas:

- Establishing and enforcing democratic rules of governance to replace the East Asian system of coordination and cooperation over time;
- Improving the quality, effectiveness, and efficiency of the delivery of public services;

- Reducing the incidence of corruption that has become systemic and, in recent years, more pervasive, in government, the business sector, and financial institutions;
- Enhancing the effectiveness of the judiciary system;
- Developing an effective system of regulations.

The market-led strategy does not mean that East Asian governments have no important role to play and must blindly move toward becoming minimalist states. The challenge facing East Asia is, rather, to develop strong but limited governments able both to resist political pressures for market intervention and to accept market-led growth (Bardhan, 1997). Within such a framework, the East Asian countries may have a better chance of managing the industrial policies required by the World Trade Organization (WTO) framework to facilitate technology transfers and to manage limited intervention in the market when market failures dictate stronger action. This means that the reform priorities include developing rules and norms that will provide government officials with incentives to act in the collective interest while controlling corruption and arbitrary actions.

At the sectoral level, two areas of reform merit attention. One area concerns reform of the financial sector. Theory and experience fail to prove that a market-oriented financial system is effective in promoting economic development and financial-market stability in emerging-market economies. In fact, many East Asian countries, particularly those at early stages of development, may have to improve the efficiency and stability of their banking systems before entertaining the idea of developing money and capital markets. In a world of increasingly globalized financial markets, however, some East Asian economies may find it desirable to reduce indirect financing by financial intermediaries gradually in favor of direct capital-market financing. If there is one lesson to be learned from the crisis, it is that East Asian corporations will be unable to maintain robust growth unless they reduce their leverage by going directly to capital markets, rather than banks, for their investment financing. The more developed East Asian countries may therefore attempt to develop simultaneously both market-based and bank-based financial systems. Both systems require rules for prudential regulation, supervision, and administration, although the development of capital markets requires a more elaborate legal infrastructure and set of regulations. Development of the regulatory and legal infrastructure may in turn require a medium-term strategy in which reforms involving capital adequacy, loan classification, loan-loss

provisioning, risk management, and corporate governance are implemented on the basis of international codes and standards.

The second area of reform relates to corporate restructuring. Despite their problems of inefficiency, nontransparency, and inadequate governance, the dismantling of East Asia's family industrial groups may not be desirable at this stage of development. The experiences of Western economies suggest that better governance, transparency, the building of market institutions, and the protection of minority stockholders will, over time, strengthen the market discipline affecting these industrial groups and will weed out those that are inefficient. Increased competition from domestic-market liberalization, integration into the global system, and the growth of knowledge-based industries will also reduce the traditional advantages these large groups have had (World Bank, 2000b). It is also worth noting that East Asian industrial groups are not so much products of Asian values as they are of a certain stage of economic development. Some of today's Western industrial icons, such as Ford, Thyssens, and Siemens, began as family businesses ("The Asian Capitalism: The End of Tycoons," *Economist*, April 29–May 15, 2000).

Finally, in promoting institutional reforms and institution building, the East Asian countries will be well advised to appreciate local constraints and to rely more on local knowledge than on the so-called best-practice model of Western and foreign advisors (Rodrik, 2000). Without proper indigenization and assimilation of Western reforms, the new institutions may be ignored or circumvented.

A more serious problem is that the crisis countries may not benefit from the signaling function of Western reform, telling foreign-market participants that the crisis countries are indeed transforming themselves to develop institutions compatible with those of Western societies. During a normal period, market participants will most likely be indifferent to the quality of institutions in emerging-market countries. Once these economies are perceived to be vulnerable to crisis, however, market participants will seize the opportunity to scrutinize institutional quality and the ability of these countries to implement reform. If foreign investors discover that the reform is superficial, they will withdraw their investments, precipitating a crisis (Pistor, 2000).

## 9 Concluding Remarks

The economic recovery in the East Asian countries has been impressive by any measure of performance. Recovery began approximately one year



after the crisis erupted in July 1997 and accelerated through 2000. Indeed, following a year of robust growth in 1999 (except in Indonesia), the crisis countries recorded higher rates of growth than expected in 2000, ranging from 4.8 percent in Indonesia to 8.8 percent in Korea. The global economic downturn, however, which has deepened in recent months, has dealt a severe blow to the region's exporters, clouding the prospects for economic growth for 2001.

Despite the recent slowdown, the pace of recovery in East Asia has been much faster than other crisis episodes would predict (Park and Lee, 2001a). What are the developments that are driving the rapid recovery in these former crisis countries? Will the ongoing recovery continue to enable the crisis countries to return to the precrisis rates of growth or does the upswing in the economy simply reflect a sharp rebound often experienced by crisis-affected countries after sustaining a significant adverse shock? If this latter is the case, will these countries go through a period of adjustment characterized by a W-shaped pattern of growth? If the ongoing recovery proves to be durable and sustainable, however, how much of the current economic upturn can be attributed to the restructuring efforts? These are some of the questions this essay has addressed.

The East Asian crisis countries have made impressive progress toward restructuring financial institutions, reforming corporations, and building market and governmental institutions—progress that will strengthen the foundations of their economies and reduce the likelihood of a future financial crisis in the region. Much remains to be done, however. For this reason, the IMF and World Bank warn that unless these countries continue with and intensify their restructuring efforts, the prospects of regaining vitality will be less promising than some predict.

Few would deny the need for a comprehensive reform of the financial, corporate, and public sectors of the crisis countries. However, these countries lack both the resources and the institutional capacity to complete the reform programs designed by the IMF and World Bank over a two- or three-year period. These young democracies, moreover, have yet to develop an effective set of institutions that can resolve conflicts about burden sharing during, and garner public support for, the crisis resolution. For these reasons, any further pressure on these countries to expedite reform could risk disrupting fragile incipient democratic systems and derailing the ongoing recovery.

Accelerating the pace of operational restructuring at this stage would involve the governments more extensively in the rehabilitation

and recapitalization of financial institutions. Such intervention would be neither effective nor desirable, because it would meet with strong resistance from labor unions and other groups adversely affected by the crisis. It would also require another round of restructuring for the reprivatization of newly government-owned financial institutions and corporations. The alternate view, a growth-first strategy, with a market-led restructuring of financial institutions and corporations, is therefore more viable and effective for sustaining both the recovery and social stability.

The current debate about the East Asian recovery raises a number of other questions that bear significantly on the prevention of future crises and on the reform of the international financial system. One lesson of the East Asian crisis is that market participants do not seem to care about or to monitor the thrust, objectives, and progress of structural reforms in crisis countries so long as these countries are able to maintain stability in their financial markets and to sustain robust growth. Only when these countries are exposed to financial turmoil do market participants find institutional problems serious and abruptly withdraw their investments. If the markets are unable to determine whether the structural reforms are being carried out as planned in these countries, who should be monitoring them? The IMF, the World Bank, and other multilateral institutions are possible candidates, but experience shows that market participants do not trust or make use of the information made available by these institutions.

The management of the East Asian crisis also raises an important question as to when the market should take over the reform process initiated by policymakers. Can the market provide incentives to continue with desirable reforms, and when should the policymakers leave the process to the market? Insofar as these questions remain unanswered, the East Asian countries may be unable to escape easily from the danger zone of crisis, no matter how hard they try to restructure their economies. Should they wait and hope that their efforts will be judged acceptable by international lenders, even without knowing when that will be or what the conditions are? In the meantime, East Asia watches helplessly from the sidelines as the debate about reforming the international financial system largely ignores the anomalies of international financial markets. For this and other reasons, the East Asian crisis countries are considering turning to a strategy of growing out, rather than the current strategy of restructuring out.

**Appendix A: Policy Responses to Financial Crisis in Indonesia, Korea, Malaysia, and Thailand.\***

Indonesia	
Date	Description of Reform
1997	
July 11	The rupiah loses ground after speculative attacks spread to Indonesia. Bank Indonesia widens the rupiah intervention band from 8 percent to 12 percent.
August 13	The rupiah comes under heavy pressure and hits a new low of Rp2,628 per US\$1. The initial currency defense by Bank Indonesia costs US\$0.7 billion.
August 14	The governor of Bank Indonesia announces the abandonment of the exchange-rate-band system. The value of the rupiah is to be determined by market forces.
August 16	The rupiah falls to Rp2,980 per US\$1. Bank Indonesia responds by increasing interest rates, tightening liquidity, and eventually suspending the commercial-bank money-market certificate.
September 3	The Indonesian authorities announce the repeal of the 49 percent foreign-ownership limit of Indonesian stock. This leads to an 11 percent surge in the Jakarta Stock Exchange Index. The rupiah strengthens temporarily.
October 6	The rupiah hits a new low of Rp3,895 per US\$1.
October 8	Indonesia seeks IMF assistance. The exchange rate improves to Rp3,600 per US\$1.
October 28	Following the regional trend, the Jakarta Stock Index falls by 8.6 percent.
October 31	The first IMF package is announced. The program approves a US\$23 billion bailout for Indonesia for a

\*Ahmed Khalid of the National University of Singapore assisted in preparing the tables for Indonesia, Malaysia, and Thailand.

- October 31  
(*contd.*) three-year period. This includes US\$4.5 billion from the World Bank. Regional countries contribute an additional US\$17 billion as a second line of defense.
- November 1 The authorities announce the closure of sixteen unhealthy private banks (including three banks owned by the Suharto family). The rupiah improves slightly.
- November 5 The IMF executive board approves a three-year stand-by agreement for US\$10 billion (an additional US\$8 billion is pledged by the World Bank and Asian Development Bank, and other countries, mainly Asian, contribute US\$18 billion). The focus is to restore market confidence, improve the current account, limit declining growth, and contain the inflationary pressure of currency appreciation.
- November 21 State-owned companies are instructed to use 1 percent of their net profits to buy shares on the Jakarta Stock Exchange.
- December 31 The authorities announce the proposed merger of four major banks into a single institution by the end of June 1998, the privatization of state-owned banks, and greater participation of foreign institutions in owning the equity shares of banks. Weak regional banks are placed under the supervision of Bank Indonesia.

1998

- January 6 The government presents the FY1998–99 budget, which shows a 32.1 percent increase over the previous budget. The budget is based on unrealistic assumptions such as an exchange rate of Rp4,000 per US\$1, an annual economic growth rate of 4 percent, and an inflation rate of 9 percent.
- January 8 Black Thursday: The rupiah falls to Rp11,000 per US\$1.
- January 15 Indonesia reaches a second reform accord with the IMF and signs a Letter of Intent. The new agreement calls for the revision of the draft budget presented on January 6, and asks that Bank Indonesia continue a tight monetary policy, strengthen the legal and super-

January 15 ( <i>contd.</i> )	visory framework for the banking sector, accelerate the privatization program, and restructure state-owned enterprises.
January 23	The revised budget for FY1998–99 is announced, proposing a 1 percent GDP deficit under new assumptions such as an exchange rate of Rp5,000 per US\$1, zero economic growth, and an inflation rate of 20 percent.
January 27	The Indonesia Bank Restructuring Agency (IBRA) is established; external guarantees are given to all creditors and depositors of all locally incorporated banks; small depositors of closed banks are compensated.
February 10	A currency-board system is proposed and detracts attention from the IMF package.
February 13	International pressure is brought to bear to drop the currency-board proposal. Fifty-four weak banks are transferred to the IBRA; new loan-classification and provisioning rules based on international standards are introduced.
March 4	First review of the IMF program: The focus is on exchange-rate stabilization and inflation control.
March 7	US\$3 billion in IMF aid is deferred (in response to the political transition).
April 4	The IBRA takes over the seven banks that had borrowed more than Rp2 billion. Seven small banks are closed, and their deposits are transferred to a state bank, Bank Negara Indonesia.
April–May	Tension and political instability increases. The rupiah falls to Rp17,000 per US\$1.
May 4	First review of the stand-by arrangement: US\$1 billion is disbursed.
May 18	The World Bank postpones two loans (in response to political instability).
May 19	Mr. Suharto's announcement of his impending resignation improves the rupiah from Rp17,000 to Rp13,000 per US\$1.

- May 21 Mr. Suharto resigns; Mr. Habibie becomes the new president; the rupiah shows some improvement.
- May 29 Bank Central Asia is brought under the auspices of the IBRA to stop a run on the bank.
- June 2 The IMF and World Bank indicate that they will resume the loan extensions and the next tranche.
- June 4 Indonesia and the private Foreign Commercial Debt Steering Committee sign a debt agreement (the Frankfurt Agreement) to design a framework for the restructuring of external debt.
- June 24 Indonesia and the IMF reach agreement on the third amendment to the stand-by arrangement.
- July 15 Second review of IMF program: The focus is to restore the distribution system and strengthen the social safety net. The stand-by agreement is increased by US\$1 billion for corporate-debt restructuring.
- July 29 A Letter of Intent and Memorandum of Economic and Financial Policies are issued for additional measures.
- August Internationally recognized audit firms review the portfolios, systems, and finances of the IBRA banks and major non-IBRA banks.
- August 25 Third review of the stand-by arrangement: The stand-by agreement is replaced by the extended agreement: US\$6.3 is pledged for the next twenty-six months, with US\$2 billion to be contributed by the World Bank and Asian Development Bank and US\$1 billion to come through bilateral sources.
- September 1 The special commercial court established under the newly amended bankruptcy law begins accepting bankruptcy filings.
- September 11 Indonesia and the IMF agree to the fifth amendment of the Memorandum of Economic and Financial Policies.
- September 23 Agreement is reached on the rescheduling and refinancing of bilateral external debt to official creditors.

- September 25 First review of the Extended Fund Facility (EFF): US\$940 million is disbursed.
- September 30 Bank Mandiri is created by a merger of the four largest state-owned banks.
- October 19 A Letter of Intent and Supplementary Memorandum of Economic and Financial Policies are issued.
- October Restructuring plans for IBRA banks are prepared.
- November 6 Second review of the EFF: US\$960 million is disbursed.
- November 13 A Letter of Intent and Supplementary Memorandum of Economic and Financial Policies are issued.
- December 15 Third review of the EFF: US\$957 million is disbursed, bringing total disbursements to US\$9 billion since November 1997.

1999

- January 6 The fiscal budget for FY1999–2000 is announced: 0 percent GDP growth is forecast for 1999–2000 as compared to –13.8 percent during 1998–99; expenditures are expected to fall by 17.3 percent; the budget will be balanced, rather than exhibit an expected deficit of 8.5 percent deficit.
- January 12 New banking regulations are issued, tightening the rules on related-party and other lending.
- January 25 The rupiah depreciates again to Rp9,500 per US\$1.
- January 26 The government announces tax exemption of up to eight years for new investments in twenty-two industries located outside Java and Bali (which are limited to five-year exemptions).
- January Inflation declines to 71 percent from the 78 percent recorded in December 1998.
- February 26 The budget is passed by the assembly with minor changes.
- March The rupiah improves and stabilizes at about Rp8,800 to Rp8,900 per US\$1.

March 10	The World Bank issues a country-assistance strategy for Indonesia.
March 13	The government announces the closing of thirty-eight domestic private commercial banks, the nationalization of seven others (taken over by the IBRA), and the recapitalization of nine more, subject to their raising 20 percent of the needed capital by April 21.
April	The Standard Chartered Bank of the United Kingdom buys a 20 percent stake in Bank Bali for US\$56 million. ANZ Panin Bank agrees to buy the credit card business of the liquidated Bank Papan Sejahtera for A\$7 million.
May 14	The fourth Letter of Intent to the IMF is issued. Another tranche of US\$460 million is disbursed; disbursement of about US\$10 billion is to be completed by May 1999 (of the total US\$12.3 billion committed by the IMF).
May	The rupiah gains and stabilizes at about Rp8,000 per US\$1.
May 17	The new central-bank law is approved, authorizing Bank Indonesia to set monetary targets without government intervention. Under the new law, the president is barred from dismissing the governor or any other board member.
May 28	The authorities announce the structure of the bond issue linked to the bank-rescue plan. The total amount to be raised under this plan is expected to be about Rp157.6 trillion.
July 7	Two hundred and thirty-four companies register with the Jakarta Initiative Task Force to facilitate out-of-court settlements.
July 15	The finance minister announces revised estimates of the bank-recapitalization cost as Rp550 trillion (US\$73 billion). Standard and Poor's estimate shows a cost of US\$87 billion.



July 22	Ten holding companies are formed to consolidate Indonesia's 159 state companies.
August 30	East Timor consultation ballot is scheduled.
October 20	The People's Consultative Assembly (MPR) selects Abdurrahman Wahid as president.

#### Korea

Date	Description of Reform
1997	
January 23	Hanbo Steel (the fifteenth <i>chaebol</i> ) files for bankruptcy.
March 19	Sammi Group (a small <i>chaebol</i> ) fails, provoking fears of a looming corporate-debt crisis.
April 21	Jinro Group (the nineteenth <i>chaebol</i> ) files for bankruptcy.
May 28	The Daenong Group (the eighth midlevel <i>chaebol</i> ) files for bankruptcy.
July 15	Kia Motors files for bankruptcy.
October 24	Standard & Poor's downgrades Korea's sovereign-credit ratings from AA- to A+ (long-term) and A1+ to A1 (short-term)
October 27	Moody's downgrades Korea's sovereign-credit ratings from A1 to A2 (long-term) and P1 to P2 (short-term). Dow Jones stock prices plunge 7.2 percent (a record drop of 554 points).
November 19	The Ministry of Finance and Economy (MOFE) announces a comprehensive plan for financial-market stabilization and financial restructuring. The width of the daily trading band for the won is increased from 2.25 percent to 10 percent.
November 21	The MOFE announces the decision to seek a rescue package from the IMF.

- November 25 The MOFE announces the Depositor Protection Scheme, by which the MOFE insures all deposits for three years until 2000. The stock markets slide 5 percent.
- November 26 Standard & Poor's downgrades Korea's sovereign-credit ratings from A+ to A- (long-term) and from A1 to A2 (short-term)
- December 2 The MOFE suspends the operations of nine merchant banks: Chungsol, Coryo, Hangdo, Hansol, Kyongnam, Kyungil, Samsam, Shinsegae, and Ssangyong.
- December 3 The MOFE agrees to accept financial support from the IMF; approves the first Letter of Intent.
- December 10 Moody's downgrades Korea's sovereign-credit ratings to junk-bond status, from A3 to Baa2 (semijunk; long-term) and from P3 to NP (junk-bond; short-term). The MOFE announces a financial-stabilization plan, including the suspension of an additional five merchant banks.
- December 11 The stock-investment limit for foreigners is increased to 50 percent. Standard & Poor's downgrades Korea's sovereign-credit ratings from A- to BBB-.
- December 12 To stabilize the financial markets, the Bank of Korea announces W7.3 trillion in funding for fourteen merchant banks, raises the limit for foreign ownership of corporate bonds of conglomerates from 10 percent to 30 percent, raises the limit on nonguaranteed convertible bonds and convertible-bond investment of conglomerates from 30 percent to 50 percent, and abolishes the limits on nonguaranteed corporate bonds and convertible bonds of small and medium-sized enterprises.
- December 16 The legal interest-rate ceiling is raised from 25 percent to 40 percent. A timetable is established for the opening of the short-term financial market by February 1998. The limit for foreign investment in financial institutions is raised (with authorization needed to acquire more than 4 percent in bank securities).

- December 21 Moody's downgrades Korea's sovereign-credit ratings for long-term debt to Baa2 (junk bond).
- December 23 The selling rate for US\$1 cash breaks W2,000. Standard and Poor's downgrades Korea's sovereign-credit ratings from BBB- to B+ (junk bond). Limits on investment in corporate bonds are abolished. Foreign participation in government-bond investments is approved, with a limit of 30 percent per item.
- December 30 The IMF provides US\$2 billion of early support funds (third disbursement). All limits on foreign investment in long- and short-term corporate and government bonds are lifted.

1998

- January 8 The IMF approves the third Letter of Intent drafted by the Korean government; approves the withdrawal of US\$2 billion.
- January 29 The MOFE announces the results of the New York negotiations for the resolution of short-term external debt.
- January 30 The MOFE announces the list of ten merchant banks to be closed.
- February 14 Eleven laws concerning corporate restructuring and employment adjustment are passed by the national assembly:
- (1) Laws Concerning External Audit of Joint Stock Corporations;
  - (2) Banking Act;
  - (3) Securities and Exchange Law;
  - (4) Corporate Reorganization Act, Composition Act, and Bankruptcy Act;
  - (5) Tax Exemption and Reduction Control Law;
  - (6) Corporate Tax Law;
  - (7) Foreign Investment and Foreign Capital Inducement Law;
  - (8) Monopoly Regulation and Fair Trade Act;
  - (9) Labor Standards Act;
  - (10) Manpower Leasing Act;
  - (11) Labor Insurance Act.

- February 17 Standard and Poor's upgrades Korea's sovereign-credit ratings from B+ to BB+. The IMF approves Korea's fourth Letter of Intent; approves a withdrawal of US\$2 billion. The MOFE revokes the licenses of ten merchant banks.
- March 16 The MOFE announces results of the negotiations to roll over short-term debts. US\$21.839 billion in loans are rescheduled (94.8 percent of all targeted short-term loans as of March 11). One hundred thirty-four financial institutions from thirty-two countries agree to the rescheduling.
- March 30 Moody's upgrades its forecast for Korea's long-term credit rating from a review for possible downgrade (in January 9, 1998) to "stable."
- April 1 The Financial Supervisory Commission (FSC) is inaugurated and the financial supervisory regulations amended.
- May 7 The MOFE announces an IMF fund withdrawal and the second-quarter Letter of Intent. The Korean government and the IMF agree on more realistic macroeconomic indicators, additional expansion of the fiscal deficit, and more flexibility of monetary and interest-rate policies.
- May 22 The IMF holds an executive board meeting and, after reviewing the second-quarter Letter of Intent, approves the sixth payment, of US\$1.8 billion. Of the total estimated US\$21 billion allocated, US\$16.9 billion (81 percent) has been provided.

1999

- January 1 The FSC extends prudential rules governing commercial banks to specialized and development banks, taking into account the specific characteristics of the institutions, and updates its regulations to bring them into closer compliance with international best practice as expressed in the Basle Committee's Core Principle. The FSC upgrades Korean accounting, auditing, and disclosure procedures to meet international best practices.

January 4	Standard & Poor's upgrades Korea's sovereign-credit ratings to BB+.
January 15	The MOFE and the Japanese Ministry of Finance agree on short-term funds assistance to Korea.
January 19	Fitch IBCA upgrades Korea's sovereign-credit ratings to investment grade, from BB+ to BBB-.
January 25	Standard & Poor's upgrades Korea's sovereign-credit ratings to investment grade, from BB+ to BBB-.
February 12	Moody's upgrades Korea's sovereign-credit ratings to investment grade, from Ba1 to Baa3. The FSC permits a decrease in paid-in capital at Choheung bank. The MOFE decides to repay US\$1 trillion in Supplemental Reserve Facility funds due on February 19.
March 31	The FSC extends relevant banking regulations to insurance companies in the areas of loan classification, provisioning, large exposure, connected lending, and disclosure rules; introduces ceilings on insurance companies' total lending and stock holdings; strengthens its prompt corrective action framework; and introduces the EU solvency margin standard.
July 22	The government designates specialist dealers in government bonds.
July 23	The FSC extends the duration of business suspensions for thirteen mutual trust funds.
July 24	Fitch IBCA upgrades Korea's sovereign-credit ratings and industrial-bank credit ratings from BBB- to BBB.
July 25	The FSC cancels the business permit for Daehan Merchant Bank. The government announces a normalization plan for management of Korean First Bank.
July 29	The government exchanges memoranda of understanding to sell Kukmin Life abroad.
July 30	The government plans to inject funds into Seoul Bank and Daehan Life Insurance (for recapitalization).

August 6	The government injects W1.3 trillion into Daehan Life Insurance and announces a normalization plan for the company after its transformation into a public insurance firm.
August 25	The government, five <i>chaebol</i> , and three creditor financial institutions agree on the three reform agendas of corporate restructuring and the seven practical-action plans and determine the direction of corporate reform.
September 18	The FSC agrees to sell Korea Bank to New Bridge for W500 billion.
November 1	Daewoo creditors settle on a workout of six Daewoo subsidiaries.
November 11	Standard & Poor's upgrades Korea's sovereign-credit ratings from BBB- to BBB.

#### Malaysia

Date	Description of Reform
1997	
July 8–14	Bank Negara defends the ringgit after it comes under speculative attack.
August 27	The Kuala Lumpur Stock Exchange (KLSE) bans the short selling of 100 blue-chip stocks. To discourage the sale of stocks, sellers are required to deliver physical share certificates to their brokers before selling. The settlement period is also reduced from five to two days.
September 3	A plan is announced to use funds from the Employees Provident Fund to prop up share prices by buying stocks from Malaysian shareholders (but not foreigners) at a premium above prevailing prices.
September 4	The ringgit falls to M\$3 per US\$1, and the Kuala Lumpur Composite Index drops below 700 points.

- October 17 The 1998 budget announces selective import duties to reduce the current-account deficit.
- December 5 The government cuts the 1998 growth forecast from 7 percent to 4 or 5 percent. The budget unveils a reform package stipulating an 18 percent reduction in government spending, an indefinite postponement of all public-sector investment, a halt to new overseas investment by Malaysian firms; a freeze on new share issues, the restructuring of companies, and a 10 percent cut in the salaries of government ministers.
- December The ringgit plunges to a new low of M\$3.87 per US\$1.
- December 18 Deputy Premier Anwar halts high-growth policies.

#### 1998

- January 1 Measures for strengthening prudential regulations are announced.
- January 9 The government claims it has sufficient foreign reserves and rules out an IMF bailout.
- January 20 Bank Negara Malaysia announces a blanket guarantee for all depositors.
- March 25 A program to consolidate finance companies from eight to three and to undertake the restructuring and recapitalization of the banking system is announced.
- May 30 GDP declines by 1.8 percent, on a year-to-year basis, in the first quarter of 1998. The GDP growth forecast is further reduced to between 2 and 3 percent.
- June Danaharta Nasional Berhad (a public asset-management company) is established.
- July 24 Moody's and Standard & Poor's downgrade Malaysia's long-term foreign-currency ratings.
- July 27 A plan to bring about the consolidation of fifty-eight financial-industry institutions is announced.
- August Danamodal (a limited-liability company designed to recapitalize and rationalize banks) and the Corporate

August ( <i>contd.</i> )	Debt Restructuring Committee (CDRC) are established.
August 27	Bank Negara announces a contraction of 6.8 percent in second-quarter GDP on a year-to-year basis. The authorities suggest a relaxation in monetary and fiscal policy to avoid a depression. Any possibility of capital controls is ruled out.
August 28	Bank Negara's governor and deputy governor resign.
August 29	Dr. Mahathir says there is no plan for capital controls.
August 31	Malaysia bars offshore trading of Malaysian company shares. KLSE says trades on Singapore's over-the-counter Central Limit Order Book market are no longer recognized.
September 1	More stringent controls on short-term-capital transactions are enforced, including a complete ban on trading in ringgit instruments among offshore banks, as well as a ban on Malaysian financial institutions offering domestic credit facilities to nonresident banks and stockbrokers. The use of the ringgit as an invoicing currency in foreign trade is banned. All ringgit deposits held outside the country will cease to be legal tender after September 30. The ringgit allowance for travel purposes is restricted to the equivalent of M\$1,000. The ringgit allowance for overseas investments without prior approval is limited to the equivalent of M\$10,000.
September 2	The ringgit is fixed at M\$3.80 per US\$1.
September 9	Bank Negara Malaysia reduces the intervention rate from 10 percent to 9.5 percent, reduces the statutory reserve ratio from 6 percent to 5 percent, and requires that banks expand their loan rate to 8 percent per year.
September 28	Morgan Stanley Capital International removes Malaysia from the Emerging Markets Free and All Country Free Indices.
October 15	The government expects recovery and anticipates growth of 1 percent.



- November 28 GDP shrinks by 8.6 percent in the third quarter of 1998.
- December 10 Malaysia receives a ¥74 billion yen loan under Japan's US\$30 billion Miyazawa Initiative.

1999

- February 4 Malaysia relaxes capital controls, replacing the one-year holding rule on portfolio principal with a system of levies on principal and profits.
- March 31 GDP contracts by 6.7 percent in 1998.
- May 26 Bank Negara issues US\$1 billion worth of ten-year global bonds.
- June 23 The KLSE hits a twenty-two-month closing high of 851.49 (KC composite stock price index).
- July 29 Malaysia unveils a plan to merge fifty-eight financial institutions into six core groups.
- August 12 Morgan Stanley Capital Investment announces it will reinstate Malaysia in its benchmark indices from February 2000, barring any financial-policy reversals.
- August 25 The authorities confirm the end of the recession, because GDP grew by 4.1 percent during the second quarter.
- September 2 Capital controls are relaxed further: foreign money managers are allowed to repatriate funds.
- October 29 The 2000 budget containing stimulus measures is introduced.

Thailand

Date	Description of Reform
1997	
March	The Bank of Thailand classifies as nonperforming B100 billion in loans owned by the real-estate sector.
May	Finance One (the largest Thai finance company) collapses.

June 29	Operations of sixteen finance companies are suspended.
July 2	The baht is floated and depreciates by 15 to 20 per cent.
August 5	The operations of forty-two finance companies are suspended. The government announces its decision to accept an IMF rescue plan.
August 11	The IMF approves a total support package of US\$17 billion for Thailand.
August 14	The first Letter of Intent is issued.
August 20	The IMF executive board approves a three-year stand-by arrangement of US\$4 billion. The World Bank and Asian Development Bank pledge US\$2.7 billion, of which Japan and other countries contribute US\$10 billion.
September	Loan-classification and bank-licensing rules are tightened.
September 4	The baht reaches an all-time low rate of B38.4 per US\$1.
October 14	The Financial Sector Restructuring Agency and the Asset Management Company are established. The blanket guarantee is strengthened.
October 24	Emergency decrees are announced to accelerate financial-sector restructuring.
November 25	The second Letter of Intent is issued.
December 8	Fifty-six suspended finance companies are permanently closed. First Quarterly Review of the IMF program: In response to deteriorating economic activity, additional fiscal measures are introduced, including indicative-range interest rates and a time frame for financial-sector restructuring.
December 31	The Bank of Thailand intervenes in a commercial bank to eliminate shareholders' stakes.

1998

- January 23 The Bank of Thailand intervenes in two commercial banks to eliminate shareholders' stakes.
- February 24 A third Letter of Intent is issued.
- March 4 Second Quarterly Review: In response to some improvement (stability) in the exchange rate and a relatively more positive economic growth rate, the program is revised; it will continue to focus monetary policy on the exchange rate but will accommodate a shift in fiscal policy and include new measures for creating a social safety net, strengthening core banking, and promoting corporate restructuring.
- March 11 One commercial bank is purchased by a foreign investor.
- March 31 New loan-classification and loss-provisioning rules are introduced.
- May 18 The Bank of Thailand intervenes in seven finance companies to eliminate shareholders' stakes.
- May 26 The fourth Letter of Intent on additional measures is issued.
- June 10 Third Quarterly Review: Minor adjustments are made to address declining GDP, including allowance for an increase in the fiscal-deficit target from 2 percent to 3 percent of GDP.
- August 14 A comprehensive financial-sector restructuring plan including bank recapitalization is announced.
- August 25 The fifth Letter of Intent on additional measures is issued.
- August 30 A majority ownership in one medium-sized bank is acquired by a foreign investor.
- September 11 Fourth review of the stand-by arrangement: US\$135 million is disbursed; the bankruptcy laws are amended; and loan classification and provision is strengthened so as to meet international standards by 2000.

September	A restructuring and privatization plan for intervened banks is prepared and a review of banking-supervision laws is begun. A memorandum of understanding with financial institutions is signed, implementing stricter loan-classification and provisioning rules.
October	The laws governing the Bank of Thailand are revised and amendments to the foreclosure laws are completed.
December 1	The sixth Letter of Intent is issued on additional measures.
December 15	Fifth review of the stand-by arrangement: US\$140 million is disbursed.
December	The disposal of assets of fifty-six (of fifty-eight suspended) finance companies is completed; a new deposit-insurance scheme and new prudential regulations are introduced, as well as stronger rules governing disclosure, auditing, and accounting practices. Plans are developed for privatizing institutions undergoing state intervention.

1999

March	Parliament approves additional amendments to the Bankruptcy Act (the act establishing the bankruptcy court) and to the Code of Civil Procedure on Legal Execution and the Code of Civil Procedure on Petty Cases to facilitate corporate restructuring.
March 23	The seventh Letter of Intent is issued.
April 7	Sixth review of the stand-by arrangement: In order to stimulate the economy, the IMF agrees to increase the public-sector-deficit limit from 3 percent of GDP (stressed in 1997–98) to 5 percent (later increased to 6 percent); to increase to 1 percent of GDP the allocation for spending on social safety nets and related labor-intensive projects; to ease monetary policy in order in order to stimulate consumption and encourage new investment; to allow the authorities to proceed with the proposed merger and sale of financial

- April 7  
(*contd.*) institutions, and to revise the time frame for the re-capitalization of these institutions. The IMF releases an additional US\$500 million.
- March 30 An economic stimulus package of B53 billion is announced that includes a temporary two-year reduction in the value-added-tax (VAT) rate from 10 percent to 7 percent, the elimination of the 1.5 percent VAT for (small) businesses having a turnover of less than B1.2 million (US\$470 million), and an income-tax waiver for those earning less than B50,000 a year.
- June 16 The IMF executive board approves the release of an additional US\$520 million.
- June 18 The Central Bankruptcy Court opens.
- September 21 The eighth Letter of Intent is issued: Thailand announces its decision not to access additional financing available under its program with the IMF. In order to support recovery, the government plans to maintain a supportive monetary stance and fiscal stimulus, to reduce NPLs, and to accelerate privatization of intervened and state banks.
- October Krung Thai Bank (the largest state bank) is split into one solvent bank and an asset-management company, which is fully owned by the Financial Institution Development Fund.
- November 30 The Thai cabinet plans to approve the new Financial Institutions Law, amendments to the Currency Act, and the new Central Bank Act. The Bank of Thailand drafts a new deposit-insurance scheme.

### **Appendix B: Financial Repression and Crony Capitalism**

Among those who argue that a weak financial system was one of the primary causes of the East Asian crisis, Barry Eichengreen (1999) provides the most scathing critique of the East Asian financial system. This appendix briefly summarizes Eichengreen's arguments, then shows why they are inconsistent both with the evidence and with theory.

According to Eichengreen, for more than three decades preceding the crisis, East Asian countries had used the banking system as an instrument of industrial policy, that is, as the means of mobilizing savings and allocating them to strategic industries and favored projects. Although this strategy succeeded in sustaining rapid growth and industrialization for almost three decades before the crisis in 1997, it resulted in a very weak and inefficient financial system, deficient in many respects.

One weakness, Eichengreen declares, was that banks became too big to fail. The moral hazard associated with the implicit government guarantee of a bailout led to poor risk management, which in turn caused a massive deterioration in the quality of the assets held by the banks. Another weakness was that direct government control over the management of, and credit allocation at, banks and other financial institutions left little room and few incentives for the regulatory authorities to develop and improve their capacity for prudential supervision and regulations. The failure to require banks to follow rigorous auditing and accounting practices made bank balance sheets nontransparent. This lack of transparency and disclosure created a fertile ground for corruption, the cumulative effect of which was manifested in poor economic performance.

Eichengreen also states that the dominant position of banks interfered with and delayed the diversification of financial assets, institutions, and markets. In particular, he maintains, the dominance of banks as intermediaries inhibited the development of capital markets, which require detailed information about the financial positions and legal structures of firms, so as to protect minority stockholders. Financing through capital markets rather than banks, including the greater use of financial derivatives, and liberalizing the capital account all demand a reliable disclosure system. Insofar as the East Asian countries were relying on banks for financial intermediation, the East Asian countries were less inclined to improve accounting, auditing, and disclosure standards. Government control of banks, moreover, created opportunities for crony capitalism, because bank owners and managers could easily collude with politicians to further their interests.

Eichengreen argues that during the early period of economic development in East Asia, when high-return investments were abundant, the industrial policy of using banks as instruments of resource allocation posed no serious efficiency problems. Once these opportunities were exhausted, however, sustaining rapid growth required a more efficient allocation of resources, which, in turn, dictated liberalizing and opening

domestic financial markets. The East Asian governments, however, stuck to the old strategy of bank-dominated control. Because the government directed credit allocation in a way that disregarded market signals, nonperforming loans eventually began to pile up at the banks and threatened their solvency.

Paul Krugman (1994) was the first to point out that East Asia was running into diminishing returns and that rapid growth was being sustained only by massive infusions of capital, much of it foreign and in the form of short-term credits. Eichengreen supports this argument and claims, in addition, that the East Asian governments decided to liberalize the capital account to facilitate borrowing from abroad, not to improve the efficiency of the economy. Unfortunately, they did it backward, he argues, by deregulating short-term borrowing first.

The discussion that follows argues that financial weakness was not necessarily one of the main causes of the East Asian crisis, although it exacerbated financial instability and economic contraction once the East Asian currencies came under speculative attack (Furman and Stiglitz, 1998, discuss this in detail). No theory or empirical evidence suggests that bank-based financial systems are more vulnerable than market-based systems to financial crises. Moreover, the East Asian financial systems have no known structural flaws that make them more susceptible than others are to financial crises. It may be true, however, that East Asian policymakers abused their financial systems as a means of industrial policy before the crisis, and that this abuse, rather than any structural characteristics of the East Asian financial systems, deepened the 1997 crisis.

Eichengreen's view is open to question because there is no clear evidence that by the mid-1990s, the East Asian policy regime was crumbling under the inefficiencies of crony capitalism and bringing the period of rapid growth to an end. A recent World Bank (2000c) report, for example, suggests that the East Asian countries managed to invest their savings productively, so that, at least until the mid-1990s, the return on capital investment remained higher than in most other developing countries (see text, Section 5). Even before capital-account transactions were liberalized and foreign-capital inflows began to increase, most East Asian countries were already growing at rates much higher than the rest of the world. In fact, it was this success and the potential for future success that attracted foreign capital to the region. Not only was there both rapid growth and domestic stability before the crisis, but the rates of return on capital were high.

In most East Asian countries, the national budget was either balanced or generating a surplus. Since the mid-1980s, all of the countries in the region had pursued trade- and financial-liberalization policies. Given the region's sound fundamentals and its commitment to liberalization, foreign investors saw enormous opportunities for profit and moved vast sums of money into East Asia. As a result, investment as a proportion of GDP was, in all of these countries, significantly higher in the 1990s than it had been in the 1980s. At the same time, saving rates were stable, resulting in large increases in the current-account deficits.

It may not be correct, therefore, to argue that the East Asian countries were intent on borrowing heavily from abroad to meet an ever-increasing volume of capital needed to compensate for the losses in efficiency that were slowing economic growth. Certainly, the assertion that these countries began liberalizing the capital account simply to facilitate capital inflows is at variance with the facts. On the contrary, although the East Asian countries were committed to liberalizing the capital account and trade in financial services in the long run, they were, for a number of reasons, very reluctant to do so in the early 1990s.

First, none of these countries enjoyed any comparative advantage in exporting financial services. East Asian economies were understandably concerned that Anglo-American financial institutions could easily dominate their domestic markets for financial services once they were allowed free market access. By the mid-1990s, for instance, American and European financial institutions had already established a dominant position in international investment banking in Asia (Park, 1998).

Second, it was feared that deregulating capital-account transactions could destabilize domestic financial markets. The shallowness of these financial markets, together with weak financial institutions, was likely to increase the volatility of capital movements and the exchange rate, complicating macroeconomic management.

Third, East Asian countries were cautious in opening money and capital markets, because their regulatory and supervisory systems were less standardized and effective than those of the industrial countries. Few of the East Asian countries were able to meet the necessary information and disclosure requirements for capital-account liberalization. Despite this weak capacity in prudential supervision and regulation, Western governments were applying increasing pressure to secure right of access for their financial firms in East Asia (Park, 1996).

Although these same Western governments knew that accounting practices and disclosure requirements in East Asia did not conform to



Western standards and that financial supervisory authorities were not capable of enforcing rules and regulations, few of them demanded that financial supervision be reformed before they entered East Asian financial markets. Instead, they persisted in their demands for equal access and the outright opening of domestic capital markets. Their justification for their impatience was that unless financial opening and liberalization were carried out quickly, the inertia would become too great and these countries would never liberalize. They ignored the possibility that pell-mell liberalization could invite speculative attacks and financial crisis in these small emerging-market economies, and they failed to realize that once capital accounts were deregulated, the East Asian economies could not deal with a large capital inflow, because their financial markets were too shallow; they simply could not accommodate large amounts of foreign capital in the short run without disruption. For this reason, even a well-functioning system of supervision and regulation of financial institutions would not have been able to minimize the disastrous consequences of the capital inflow. To be sure, it would have made the crisis less painful; if banks had been more cautious in their real-estate lending, for instance, domestic borrowers could have gone directly to the international financial markets, as they did in Indonesia (see Furman and Stiglitz, 1998; Radelet and Sachs, 1998a, 1998b; and Hellmann, Murdock, and Stiglitz, 2000).

Prior to the crisis, foreign lenders had access to much of the information needed for investment decisions, including information that the balance sheets of banks and corporations in East Asia were unreliable. Foreign-market participants either ignored or were unable to process the available information. If the lack of transparency and the inadequate disclosure of information made East Asia vulnerable to financial crises, how serious was the problem? Furman and Stiglitz (1998) show that increased transparency in the form of disclosure requirements is not needed, because markets can and do provide optimal incentives for disclosure. They also argue that under certain circumstances, information disclosure could exacerbate fluctuations in the financial markets and precipitate financial crisis (you don't cry "fire" in a packed theater).

The seriousness of crony capitalism or widespread corruption in East Asia was also well known to foreign investors, although according to several measures, the risk of corruption had either declined or remained unchanged before the crisis (Furman and Stiglitz, 1998).<sup>20</sup> It

<sup>20</sup> A recent measure of corruption in Asia by Political and Economic Risk Consultancy, Ltd. (2000) shows that the trend of corruption in all four crisis countries has been rising.

is also instructive to note that the Nordic countries, which suffered less from nontransparency than the East Asian countries, could not fend off crisis in the early 1990s (Rodrik, 1999).

Foreign investors knew quite well that East Asian firms, both small and large, relied almost exclusively on banks for their investment financing and working-capital requirements. In such a bank-oriented financial system, it is only natural to expect that the debt-equity ratios of these firms will be much higher than firms operating in economies where capital markets are well developed. Apparently, before the crisis, foreign lenders did not consider that this balance-sheet weakness would pose serious default and liquidity risks or that the weakness was serious enough to discourage their lending to those highly leveraged firms. Once the crisis erupted, however, they suddenly cited the lending problem as one of the major vulnerabilities of the East Asian economies.

The East Asian experience also raises the question as to why the countries in the region did not initiate financial reform earlier to loosen control over financial institutions and markets and to develop a more balanced financial system in which capital markets compliment the banking industry. There were several reasons for their reluctance to follow a liberal reform. One reason was the problem of inertia and complacency bred over a long period of rapid growth before the crisis. As far as the East Asian economies were concerned, the bank-dominated financial system had worked very well in sustaining rapid growth and industrialization. There were no compelling reasons to tinker with the system until they were forced to open their fledgling capital markets to foreign competitors.

Another reason had to do with a theoretical justification for both financial restraint and reliance on a bank-dominated financial system in developing countries. Problems with incomplete information, markets, and contracts tend to be most severe in the financial sector. In any economy, whether developed or underdeveloped, these deficiencies weaken and sometimes break down the functions of the financial system. Failures of the financial systems can be more frequent and serious in developing economies where the markets are shallow. Furthermore, in many developing countries, effective legal and regulatory systems often do not exist. Under these circumstances, governments of developing countries often intervene and impose restraints on lending and other operations of banks to improve the efficiency of the financial sector.<sup>21</sup>

<sup>21</sup> Government intervention cannot be justified, however, if the legal and regulatory systems are not efficient and reliable.

Stiglitz and Uy (1996) and Stiglitz (1998) argue that financial restraints, or repressive financial policies in East Asia had their share of problems but made an important contribution.<sup>22</sup> For example, deposit-rate controls increased the franchise values of banks and thus discouraged them from taking excessive risks that might have destabilized the financial system. One might therefore argue that the economic costs resulting from financial restrictions were more than offset by the gains from greater financial stability and that the removal of financial restraints was one of the causes of crisis in East Asia.

The literature on finance and development suggests that the more pronounced the information asymmetries are and the higher the transactions costs, the more preferable banking arrangements are to direct securities markets. In developing economies, where informational problems are severe because accounting and auditing systems are typically not reliable and shareholder rights are not adequately protected, banks assume a more important role than in advanced economies. In the course of development, institutions specializing in gathering, assessing, and disseminating information appear, as do regulatory agencies to enforce greater disclosure, and legal systems to enforce contracts and protect the rights of investors. This institutional development makes it possible to nurture bond and stock markets. In practice, however, banks have remained the dominant source of external financing, even in advanced countries.

There is also the argument that bank intermediaries are more efficient than open securities markets for supplying long-term financing to industry. One reason for this is that banks can lengthen the investment horizon of firms while they monitor the activities of their borrowers. Another is that banks can also enter into repeated relationships with borrowers in order to mitigate informational distortions. This relationship banking can, in turn, facilitate the provision of long-term (or at least ongoing) credit.<sup>23</sup>

<sup>22</sup> Hellmann, Murdock, and Stiglitz (2000) distinguish financial restraint from financial repression. The former is used to improve the efficiency of financial markets, whereas the latter is designed as a mechanism for the government to extract rents from the private sector. In reality, however, such a distinction cannot easily be made.

<sup>23</sup> Mayer (1988) argues that competition in financial markets can have time-inconsistency costs that result in a decline in long-term financing. Yanelle (1989) shows scale economics and Bertrand oligopolistic competition that imply that unfettered competition in financial intermediation is not likely to be realized and that deregulated banking may not lead to an efficient allocation of resources.

In two recent papers, Demirgüç-Kunt and Levine (1999) and Levine (2000) show that well-developed financial systems exert positive influences on economic growth, independently of whether they are dominated by banks and other financial intermediaries or financial markets. Their cross-country study, however, indicates that neither intermediary-centered nor market-centered financial systems are associated with high growth in countries at any stage of economic development—that is, the financial structural characteristics pertaining to dominance, either by financial intermediaries or markets, are immaterial to promoting economic growth. Instead, The authors find that the legal environment and development are more critical to financial development than are financial structural characteristics.

La Porta et al. (1999) suggest that the legal environment for investor protection and contract enforcement is the most critical determinant of the level and quality of financial services, and thus to the development of both financial intermediaries and markets. According to this view, a well-functioning legal system could nurture economic development, because it facilitates the operation, and improves the efficiency, of both financial institutions and markets. The authors therefore argue that the debate about the relative merits of intermediary-centered or market-centered financial systems is not analytically meaningful in either advanced or developing countries.

Although the importance of the legal environment cannot be denied, it should also be pointed out that the legal argument does not prove that banking arrangements are less efficient or less desirable than direct securities markets are in mobilizing and allocating savings in developing economies. Demirgüç-Kunt and Levine (1999) show that national financial systems tend to become more market-oriented as countries become richer and develop well-functioning legal systems. In most developing countries, however, the existing legal systems provide little protection for shareholders' and creditors' rights or for contract enforcement. With accounting practices and disclosure requirements failing to meet international standards, moreover, information asymmetries are more serious and transaction costs are higher. As long as these structural problems impede the development of market-based financial systems, therefore, developing economies may have to rely on bank-based financial systems, at least in the early stage of development. To be efficient, however, the system should be free of undue state influence, be exposed to competition, and be prudently regulated. As discussed in Section 7, however, one of the reform priorities of the crisis economies should be the development of capital markets.

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